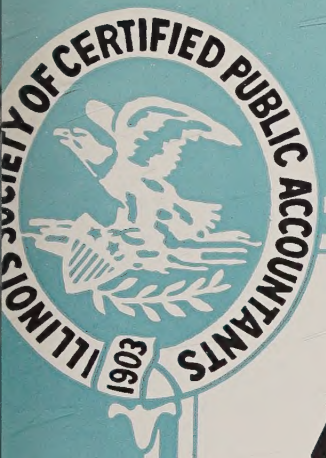


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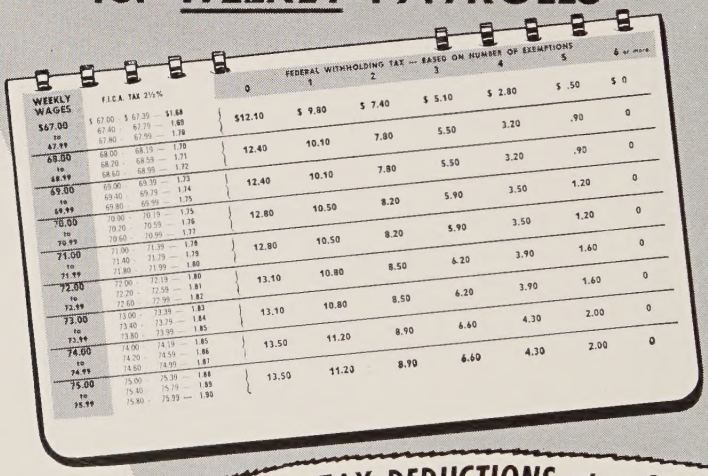
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THE ILLINOIS Certified Public Accountant

THE ILLINOIS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

WINTER 1958
VOLUME XXI
NUMBER 2

EDITOR: Nelson D. Wakefield
ASSISTANT EDITORS: Guy B. Finlay, Mandel Gomberg, LeRoy Kist, R. K. Mautz, M. J. Sporrer
BUSINESS MANAGER: Jeannette M. Cochrane

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The opinions expressed by the authors of articles appearing in this magazine are their own, and frequently are intended to stimulate further discussion on the subject. Publication of any material does not necessarily mean that the Society, its Board of Directors, or editors approve or agree with the opinions expressed by the authors. Readers are invited to submit their own comments or articles.

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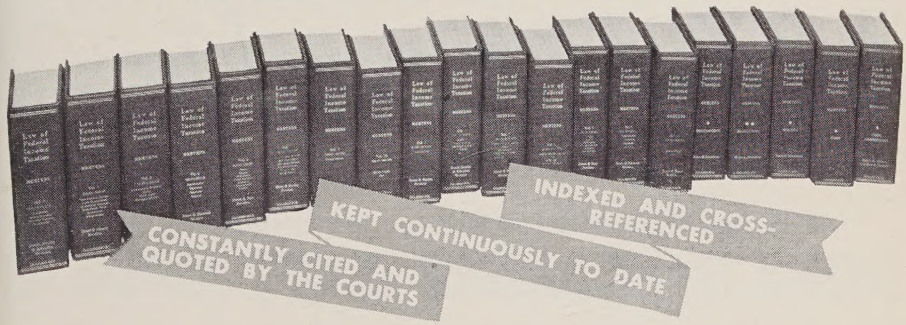
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PRESIDENT'S PAGE



We have heard a great deal recently about the expansion of services that CPAs are rendering to their clients. Much that is written and said on this subject deals with management services; however, I would like to comment on the role of the certified public accountant in another area, and one which I believe can be equally significant to CPA and client alike. This is estate planning. In this area the CPA is in no way invading the field of the attorney, trust company or life underwriter, for the CPA's interest and help will enable each of them to render a better service to their mutual client. The estate field is a "plus" service—as are management services—which the CPA can perform with greater frequency and confidence than is now in evidence.

Take, for example, the typical client of a great many CPAs, a small or medium-sized corporation, managed by the principal shareholder and controlled by one or two families. In most such client relationships, the CPA has a far more intimate knowledge of the financial affairs of the company than any other outsider. In addition, he is in the most objective position of all to discuss the matter of estate plans and to urge thorough consideration. The client's attorney may be hesitant to raise the subject as he might fear the client would suspect him of self-service. The trust company and life underwriter often have difficulty interesting the client since their business, the selling of trust services and life insurance, precludes a wholly unbiased view. We all know it is only prudent to plan one's estate, but it is a matter easily postponed. Through his periodic contact, the CPA can keep the client's interest in the subject alive and diplomatically work toward positive action.

If the CPA participates in the development, and is kept fully informed of the estate plan of his client, he can make periodic computations reflecting how the plan will work out under the then current conditions. If the plan has become financially impracticable because of changes in the size of the estate or for any other reason, he can point out the necessity for reconsideration. No estate plan is static and periodic review is a necessity. Since the CPA is fully aware of changes in the condition of the business, he can readily interpret the effect of these changes upon the estates of the major shareholders.

Many successful business men plan most carefully for the distribution of their estates. Yet many pay little or no attention to the succession of management in the business that might well constitute the major portion of their estate. We have all seen busi-

nesses merged, sold, or even liquidated because of inadequacies of new and untrained management. The CPA's close contact with the business permits him to observe the various executives in action and to counsel with his client as to the best plan of management succession.

As in everything we do, we *must* have knowledge in this field if we are to render effective service. A wealth of information is available and, if the CPA has the interest and industry, he can readily become adequately informed. He need not become a highly specialized technician in the field. His objective should be to so equip himself that he can, when he sees the need, render an additional service to his client; he will be gratified to find how much the client will value and appreciate it. Some of the literature of our profession identifies the CPA as a member of the "estate planning team." Many practitioners keep this constantly in mind—many others, however, are overlooking a unique opportunity to be of special value to some of their clients.



THE CPA AS A CITIZEN IN HIS COMMUNITY

By Colin Park

One of the reasons why research is so rewarding is that out of it come delightful dividends of unexpected facts—unsought facts hidden under the surface. No exception to this is the survey of the public service activities of CPAs conducted last summer by the Public Relations Department of the Institute.

A year ago, the Institute's Committee on Public Relations held a meeting in which a generally favorable attitude was expressed toward such a survey. Apparently the Committee has agreed for some time on the public relations values of service activity, both to individual members and to the profession as a whole. There has been some evidence that a good deal of public service was going on, but we have never before had a reliable measure of its extent. It was suggested at the meeting that, if a survey showed public service by CPAs to be fairly widespread, this fact in itself would be an encouragment to those members who have not participated heretofore. It was thought that it might also result in a detailed list of the kinds of services rendered by CPAs which would afford an example to others of the sort of work in which CPAs are welcome and are presumably able to make a natural contribution. The results of the survey are now tabulated, and we do have answers to many questions that previously could only have been guessed at. We have *proof* that a great many CPAs are active in public service activities.

We are not advocates, generally, since avoiding the controversial position often enhances the objectivity of our work, and we do take our work seriously. But perhaps we ought to become more accustomed to the limelight, and, in doing so, be less sensitive about how other people rate us professionally, taking note of the Survey's evidence that the public-service activities of CPAs are plainly *not* narrowly restricted to accountancy talents. Yet it is disconcerting to note the opinion of a number of the Survey respondents who felt that accountants generally did not participate as greatly as they should in public-service activities. Many of these critics are themselves outstanding in their own significant public-service contributions. They are leaders holding broad responsibilities, not confining themselves to uniquely financial advisement. The paradox all this suggests is that perhaps we don't really know ourselves very well, for what we do and what we think we do seem to be two different things. What the

COLIN PARK is Director of the Executive Development Program at the University of Buffalo, Buffalo, New York. This article is adapted from a paper presented at the annual meeting of the American Institute of Certified Public Accountants which was held in New Orleans in October, 1957.

Survey reveals should help to straighten out our thinking in these respects, for about 80 per cent of our members are active in one or more public-service organizations. We think of this as relatively good performance.

How the Facts Were Gathered

Considerable care and thoughtfulness went into planning and conducting the Survey. A well-qualified market analyst was engaged to assist in preparing the questionnaire, in selecting the sample, and in tabulating the results. The size of the random sample of Institute members to whom the questionnaire was sent lends weight to the findings. A sample of about 4,000 generally would be considered by statisticians as adequate to produce meaningful results in most situations, but a larger number of questionnaires went out on the advice of our statistical consultant to make sure that the findings would be truly representative. As it developed, almost 50 per cent of the questionnaires were returned as against a 25 per cent return rate which professional pollsters consider excellent.

In addition to the tabulated results, our members' feelings were brought into sharper focus by the many original comments they volunteered. One particularly heart-warming thought read as follows:

> Service to the community through service organizations is twofold: It is a method of paying for the right and privilege of living in a social group—and it is a method of extending the opportunity of rendering the service which is our vocation.

Some Facts Selected from the Survey

In analyzing the Survey results, some editing was necessary in order to exclude political activity as such from the focal public-service area under review. Also, it is difficult to pinpoint the extent to which our members on the average actually participate in public-service organizations; but of the 7,400 organizations to which the active respondents belong, 51 per cent of these organizations have CPAs serving either as officers or committeemen. It is interesting also that, while not quite half of those who are active are affiliated with one or two organizations, *more* than half were in three or more organizations and fully 7 per cent are active in six or more organizations.

Judging from the results of the Survey, CPAs in public practice seem to be slightly more active that those in private industry. Members in medium-sized firms are a little more active than those in large firms or those in individual practice.

Age appears to affect the degree of participation as might be expected. The lowest degree of participation was reported by men in their twenties. Saddled with the problems of starting a career and family, the younger CPA is often hard put to it to give very much of his scarce time for public service. The men in the 30-45 year group are the greatest givers of time, but the slightly smaller contribution of time by CPAs over 45 is well complemented by the larger responsibilities they assume. As a matter of fact, the senior age group is more active in charitable and civic organizations while the middle group is more active in church, educational and youth organizations—just what a family man might be expected to support. The members in the youngest age group participate in fraternal organizations to a greater extent than their older

colleagues. And it is interesting to note that of all the service areas—church, charitable, civic, educational, youth, fraternal, and business—our least contribution as a group is in educational and youth activities. Perhaps this situation can be improved simultaneously with gathering momentum in achieving the objectives of the Commission on Standards of Education and Experience for Certified Public Accountants. It also suggests a fertile field of opportunity for helping taxpayers understand public schooling costs. This is one of the objectives of the Institute's new Committee on Public School Accounting, which we hope will soon have recommendations indicating how the state societies and members may contribute in this area.

As indicated earlier in this discussion, our members differ widely in their notions of the accountant's status in various public-service organizations. Significantly, one out of every four CPAs active in public-service renders *no* accounting service of any kind to the organizations with which he is connected. Furthermore, only 14 per cent of those respondents doing accounting work performed a bookkeeping service. However, three CPAs out of five active in service work serve as treasurer of at least one service organization. "The CPA will usually find himself doing the job for which he is most qualified—treasurer," said one respondent to the Survey. We should not lament serving in this capacity with the attendant thought that inflexibly this is the job to which CPAs inevitably are assigned. It is something we should do well and thus is work which permits us to serve well. Such good performance is pleasurable, and it reflects with credit upon our profession and ourselves.

Audits account for fully one-half of the accountancy services that CPAs give, and churches and charities seem to be the principal recipients. Although less than one-half of the audits command a fee, often the fees are greatly reduced, the overall picture being considerably less progressive and straightforward than that suggested by Executive Director John L. Carey in an editorial letter of November, 1956. In that letter, Mr. Carey discussed the relative merits of charging no fee at all vs. billing costs only or charging regular rates and then making a cash contribution of the approximate excess over costs. The size of the engagement and individual temperament enter into the picture, of course. Mr. Carey suggests, "that the least charitable procedure is to bill costs only. The practitioner gets neither the credit for doing the work for nothing, nor the credit for contributing the amount which normally would be partnership income." He points out that "anonymous charity is the most admirable. But this doesn't mean that the community should be encouraged to undervalue professional work by habitually receiving free service without ever realizing what it would cost if it weren't given as a contribution." One member responding to this survey suggested an interesting technique. When the firm renders a report following no-charge service-organization professional work, the covering letter includes a statement to the effect that the report was "prepared as a public service."

But let's look at a few more facts about fees as revealed by the Survey. Apparently charges are submitted for

only about one-third of the accounting work of all types our members do for public-service organizations. There is a great reluctance to bill churches for this work—as might be expected. On the other hand, businessmen's clubs typically "expect" free service, while fraternal societies (no doubt operating on a higher budget) generally pay for professional services they receive. Charitable organizations pay for a larger portion of accounting services received than any other group. But virtually none of the organizations we are discussing pay CPAs for budget and finance advisory service, strictly speaking.

Finally, many of the responding members were concerned about the lack of publicity CPAs *as a group* receive for these activities in the community interest. This indicates that we can do more, in a dignified, modest way, to publicize our contributions to community welfare. State society public relations committees are constantly trying to obtain legitimate recognition for our group's public service activity, and their efforts are increasingly effective. But the problem of what publicity measures are correct runs deeper. Perhaps the function of thoughtful planning in effective group public relations needs to be re-examined. If our state societies were to do more to detect and satisfy needs for public service contributions—thus providing the needed liaison between CPAs and those whom they might best serve—our contributions as a group could encompass larger projects and be conducted on a scale adequate to take care of those projects properly. Publicity subsequently given would be, appropriately, the responsibility of the state societies of certified public accountants and the American Institute. For public service work directly negotiated and on a smaller scale, the individual practitioner as a rule could scarcely be expected to volunteer information about it to his state society or its local chapter. As indicated previously, the diligence of state society public relations committees must be depended on to notice and report these contributions.

Considering the statistics as a whole, until we had the Survey we simply did not know what CPAs were doing to meet their public-service responsibilities. Without concrete information, previously it has been tempting to jump to conclusions. But the broad response to the Survey provides answers to many of our questions, and it is hoped that what has been touched on here will induce our members to examine the details which the Institute will make available soon to the state societies.

In summary, it is interesting to try to draw a profile of the "typical" CPA participating in public service activities:

He is in his 30s or 40s.

He can be found anywhere; in cities and in large and small towns.

He is likely to be a member of a medium-sized firm.

When he renders an accounting service to a public service organization, he usually audits the books or acts as treasurer.

More often than not, he receives no fee for the audit or other accounting services he performs.

He belongs to a church, and gives more of his time to its additional demands for his public service efforts than to any other organization.

Public Service and Professional Life

Among the principal characteristics of a profession is acceptance of

social responsibility which is "inherent in an occupation endowed with public interest." It seems apparent that our members overwhelmingly accept this principle and are eager to meet the larger challenges it implies for the future. Actually, these responsibilities are being given increasingly to CPAs as public confidence and understanding of our work grow. Full stature can be achieved only if the exercise of mature judgment is recognized as a major factor in our professional growth. It is a measure of our progress in this direction that so many CPAs are asked to assume leading positions in conducting community activities in public service. Taking some examples at the town or city level, we can cite: chairman of hospital board of directors, president of community chest, member of university board of trustees, president of home for children, member of town planning board, member of executive committee of Council of World Affairs, chairman of board of public welfare. These are but a few examples; there are many others that the Survey revealed.

Another side of this subject—apart from social responsibility itself—is the reward of pride and personal satisfaction coming from social service. There is recompense in the satisfaction one can get from public service activity, and an important facet of this is the good will a man can develop for his profession, his organization, and himself. There are, also, two more reasons why CPAs must fulfill the demands made upon their time for public service:

> In common with other professional people, when we are associated in public-service activities, trust in the integrity of these organizations is stimulated because of public knowledge of necessary honesty and dignity in professional character. Perhaps this public reaction is most clearly relatable to our profession when a CPA acts as treasurer for a public service organization.
>
> People will support public-service activities that are well organized. Our demonstrated competence in planning organization thus adds to the attractiveness to potential givers of public-service organizations in which we take part.

How much time one ought to give is a difficult question to answer. But a prominent businessman who is outstanding in his community for his public-service work suggested to me this rule of thumb: substantially one-quarter of your time—this being a maximum criterion toward which one might work during the years from initial establishment in business to the time when senior executive responsibility is reached. Perhaps some would consider unrealistic such a large allocation of time, that is, the high side of the zero-25 per cent range. Others might not. We can only say that, by inference, the Survey indicates that considerable time is spent by many members. The Survey did not ask for personal estimates of time spent in service organization work. This was a wise decision. The results could scarcely be dependable since it is probable that very few people keep accurate records of time spent on other than work activities. Moreover, when plans for the Survey were being made, it was noted that no comparable statistics for other professions were readily available.

Summary

In broad perspective, public service activity not only fulfils certain family and community needs in which we are enmeshed as thoughtful citizens, it

also contributes to the stature of our profession as a whole. Clear, defensible motives are prerequisite to our entering into community activities. Individually, all of us can benefit—though cause and effect may be difficult to discern—for our individual growth depends mightily upon our collective growth as a profession. Although the benchmarks of accomplishment are obscure, the practical approaches are no mystery. And while we are at it, we can learn a little about how that often-honored intangible, "the public interest," affects our actions as professional men.

For those who do not at present share in the pleasures and rewards of participation in public service activities, the encouraging results of the survey which have been reported should be an enticement. Because our participation already is good, a further increase could result in a higher level of performance bringing relatively greater public relations dividends to our profession. This we should try to do—quietly, modestly, and by design.

What the CPA Should Be Doing in Management Consulting Work

By Roger Wellington

In order to place in better perspective the activities that we CPAs now are calling management services, I should like to review briefly the history of the development of these services.

Management service activities by CPAs seem to me to consist of two quite different kinds. On the one hand are the informal, practical services, advice and assistance that almost every individual practitioner renders for his clients as a matter of course. These may involve almost any kind of management problem. On the other hand are the relatively formal, more specialized and larger scale management service assignments rendered by medium and larger size firms of CPAs. There is no sharp dividing line between these two varieties of management service, but there are real differences. I think it is important in our discussion here that we all keep in mind these differences, since these differences can lead to much confusion in trying to understand each other.

Questionnaires have been used by the AICPA and also the Texas Society of CPAs to survey the extent of CPA participation in management services. The replies received are confusing, because there has been no way to measure the depth or intensity of service or even to define the services simply.

I could restrict my review of the history of management services to what has happened within the profession of public accounting, but if I did, much of the needed perspective would be lost. Also my comments will be pointed initially towards the background of the relatively formal, large scale type of management service. Not that the informal kind of service is less important—it isn't and, in fact, is much more widespread and forms a much larger proportion of the total service of our profession than does the formal type. However, I think you all understand the nature of the informal kind of service, but some of you may not have had the opportunity to observe the nature and development of the more formal, more specialized services. Furthermore, I

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think that the development of a practice of professional referral is essential in our profession if management services are to be available to clients. If you are a small practitioner this will help furnish a picture of the kinds of service available.

Therefore, I shall cover first the development of management consulting —since that is really what formal management services are, even though we in our profession call it by the latter name.

The fields that management consulting now covers tend to reflect the way it has developed over the years. Firms which render management consulting services today have developed from or through four different areas of activity:

1. Industrial engineering: which in itself is an outgrowth of "scientific management" that developed in the early part of this century. Industrial engineering is concerned principally with methods, standards and the like, and also with theories of organization.
2. Marketing: which has developed from advertising and related problems and from the need for independent organizations to conduct large scale surveys of customers and markets.
3. Consulting engineering: which has been concerned with the design of factories, layout of plants, design of machines, etc., all with a view to increasing efficiency.
4. Finance and accounting: which has been concerned with measuring and reporting on the financial results of operations.

The consultants who developed in this last area, finance and accounting, include a number of accountants. As Clinton W. Bennett has pointed out, it is interesting to note that, in the early days of our profession in this country, those who practiced accountancy seemed to have had a much broader view of the scope of their practice than has been the case within the profession in recent years. In those days professional accounting practice commonly included much in the way of work connected with production management, costing, systems and other assistance to clients of an operating more than a financial reporting nature. However, stimulated by the advent of the federal income tax and wider public ownership of companies, the demands for the services of certified public accountants in the specialized fields of auditing and tax practice increased at a greater rate than did the number of accountants available. As a result, it appears that most professional accountants concentrated on services in the accounting, auditing and tax fields, and left the broader aspects of their practice, namely the management services, to be done by others. The demand for management services did not diminish. It was just that CPAs made little effort to fill the demand, with the exception of a few firms.

To fill this demand, the profession of management consulting developed, I am using the word "profession" loosely in the sense of meaning "one who holds himself out," since practically anyone can call himself a management consultant and frequently "anyone" does.

Within the general area or function of management itself many special fields of effort have developed in recent years, in addition to the rapid increase of specialization in technical and physical matters that are covered by the fields of science and engineer-

ing. Examples of these special fields of management are:

1. Marketing
2. Personnel
3. Industrial engineering
4. Finance
5. Administration.

There are numerous others that anyone familiar with business can name. Except for the very largest companies, it is costly and frequently uneconomic for a company to have fully qualified personnel in every one of these specialties since many of them do not need concentrated attention continuously. To fill the need for occasional careful attention, specialists among the management consultants have developed in each of these fields. In addition, in the field of administration the recent emergence of professional managers has been paralleled by the growth of consultants who "specialize" or "generalize" in the broad art of management and administration.

Therefore, business today is served by a large number of management consultants in this country, a few large firms and many small firms and individuals. The small ones tend to be specialists in one or very few of the fields mentioned. The large ones tend to have an organization that covers a substantial number of specialized fields and also offer the broad qualifications and viewpoint of the professional manager.

In addition to those who hold themselves out as management consultants, there are a number of other types of business advisers who help business fill its need for consulting services. Among these are manufacturers and suppliers of specialized equipment and materials, such as, for example, the business machinery and office equipment companies. Educators who are teaching in the business field often offer their services on a part-time basis. Advertising firms in recent years have attempted to give a much better rounded service than the mere development and preparation of copy and selection of media. In connection with pensions, financing and many other matters, banks offer consulting services which are aimed at bringing in additional loans and deposits. Individual lawyers and legal firms often advise their business clients on many matters not connected with the law. In addition to all these, of course, are we CPAs.

The different kinds of management consulting work range all the way from offering actually to manage a business for a client at one extreme to offering only specialized technical advice at the other. The field is nebulous, but on the other hand, at least in this country, it definitely does have public recognition. It encompasses highly specialized service such as advice about the operation of a fleet of motor transport equipment (there are some firms who do nothing but this sort of thing) as well as consultation and advice covering broad general areas of business organization and principles of management.

This, then, is the present situation. The business community has a real need for competent independent outside advice and assistance. Small businesses especially tend to be deficient in sound management and many are in serious need of help. There are a number of groups offering and rendering services to fill various portions of this need. In many cases these groups overlap in the services offered, and the quality, specialization and extent of service rendered vary widely. CPAs are filling a substantial part of

business needs for consulting services but not nearly as large or important a part as they might.

Having reviewed the development of management services, the competition and the potential market, I should like to explain why I think the CPA can be peculiarly well qualified to render constructive management consulting services to his clients, and, conversely, outline some of the problems and limitations affecting both the CPA and his client which will limit the extent to which he can perform this sort of work.

The experienced CPA should be qualified to fill the need of clients for management service and assistance because:

1. He has breadth of knowledge and experience.
2. He is independent.
3. He is familiar with office operations.

These qualifications I have mentioned so far are not peculiar to the CPA. Many reputable management consultants who are not accountants can qualify equally well in some or all of these respects, and in addition have knowledge and skill in special fields outside of those to which the CPA would ordinarily aspire—such fields as market research or plant layout. However, for this kind of work the CPA possesses several important characteristics not found commonly among individual consultants outside the profession.

1. He already knows the business and organization of his clients.
2. He knows accounting and taxes.
3. He is a member of a profession with recognized standards.

Considering these characteristics I have mentioned which should qualify the experienced CPA to perform successfully additional services for the managements of his clients, there must be sound reasons why CPAs are not more active in this work than they are. There are such limitations, and I should like to discuss some of them briefly.

1. I believe all too few businessmen, when faced with a management problem in which they think outside professional assistance might be of value, think of their certified public accountant. I don't mean to say that public accountants, particularly individual practitioners or smaller firms, are not being of constructive help to their clients. Most of them are, but they may not be getting adequate recognition from their clients and others for the constructive work done or suggestions made. I don't see how the public can be expected to identify the CPA with this kind of work unless the CPA himself takes a point of view which sees management services as a logical, useful and distinct part of his professional activities.
2. To perform management service work with any marked degree of success requires much ability and experience. Unless the certified public accountant who is now devoting his time to auditing and tax work consciously makes an effort to develop either himself or his firm in this field, he has little hope of becoming qualified or building up his practice in this area.
3. Even in their own field of accounting, there is a common tendency among practicing CPAs to ignore or overlook the important potential usefulness to management of accounting for internal control of op-

erations as contrasted with external reporting of financial results. The growing importance of this aspect of accounting is evidenced by the rapid growth in private business of the concept of the controller and his functions. Many CPAs know cost accounting, but, judging by the material covered in the publications of his professional societies, the CPA has fallen behind other groups in his attention to this field.

4. To serve the management of his clients successfully, the practitioner must have a more thorough knowledge of his client and a better understanding of the operation of the business than is usually needed for purposes of audit or taxes.
5. In this kind of work the ability to evaluate, deal with, and persuade people, and to understand how they work or don't work together, is very important in appreciating how a business operation is or can be controlled.
6. For the accountant to participate actively and directly in management decisions, as he could be led to do in this sort of work, would raise serious doubts concerning his independence when it came to auditing and giving his opinion as to financial statements for the same client. There are some who say that he cannot be both independent and perform management services for the client at the same time, but I do not agree. He does face this kind of problem continually in his present tax work, and also when he gives his clients advice on how they should handle particular accounting problems. The important thing is that he must not put himself in a position where he has any selfish interest in or cannot maintain an objective attitude toward the financial statements of his clients.
7. A serious limitation to the expansion of management services within our profession exists because of lack of professional referral in this kind of work. As the profession extends its activities into the field of management services, individuals and firms will, of necessity, have to specialize to a much greater degree. Unlike the professions of medicine and law, we as a group have to date shown a marked reluctance to refer the problems of our clients to specialists within our own profession who may be much better qualified than ourselves to deal with the particular problem. While the reasons for this attitude are understandable, I think that it is shortsighted, and in the long run will hamper the development of which our profession potentially is capable.

If the members of the profession in general are to continue to refuse to refer to others in the profession for specialized services to their clients, it seems to me that the net result will be one or more of three effects:

A. Clients who are in need of services that could be rendered effectively by someone within our profession will be forced to go outside for the needed assistance; to turn, for example, to management consultants. While there are management consulting firms doing excellent work in a number of different fields, there are firms within our profession that are equally well and, in some cases, better qualified in many of these fields.

B. Because of the refusal of a certified public accountant to bring

in outside assistance in those areas where he is not fully qualified, the client will be shut off from needed services and assistance which might be available to him from within our profession.

C. The certified public accountant may make the mistake of attempting to render the service needed and obtain substantial fees therefor, even though he is not sufficiently qualified by training or experience.

As I have pointed out many times before, there are a number of different approaches to management services. This fact has generated much of the uncertainty about management services which obviously exists within the profession. Each individual tends to think of it in terms of the approach he has in mind. The small local practitioner thinks of it in terms of the many ways he is looked to by clients for assistance, including all sorts of business and management advice. The large firm tends to regard it as a separate and distinct kind of service, specialized in nature and probably handled by a separate group within the organization.

I would group the approaches to management services by accounting practitioners into three basic categories:

1. From an accounting point of view or as an extension of accounting—in other words, management services are considered in the light of their relationship to accounting.
2. From the point of view of the general management problems of a company—in other words, consulting with management on its problems from a rather broad point of view based on extensive general experience.
3. From the point of view of specific special techniques or types of service which commonly are rendered by independent consultants.

Of all the possible areas in which the managements of many businesses—both large and small—need assistance, it seems to me that the most logical area for service or assistance by professional accountants is that of assisting in problems of managerial control. This area of service is suitable, logical, and feasible because:

1. A gradual development outward from accounting into other areas of management is the line of least resistance for most CPAs who desire to develop management services.
2. We learn about the control of finances in our basic training and normal work and this is one of the important aspects of business operations which management must control carefully.
3. The basic purpose of accounting, namely, the reporting of what has actually happened, is also one of the basic elements of control.
4. Within most well managed companies, the accounting that is carried on is performed much more for purposes of control than it is for purposes of financial reports to outsiders.

Logical first steps for a CPA getting into management services would be to develop work in budgeting and in cost acounting. This managerial accounting approach has the advantage that no sudden jump into a completely new field is required.

However, it is most important to realize that work in such fields as

budgeting and cost accounting, even though related to financial accounting, requires real knowledge of business management to be sound and effective. Furthermore, it is almost inevitable that if one gets very deeply into such areas he will find himself getting into other fields not related to accounting—such as work measurement, for example. This approach to management services has wide applicability to our profession, but to be carried out competently it must be coupled with a thorough understanding of the operations of the particular client and of its management.

As I indicated earlier in my review of the history of management services, apparently our profession of public accounting has for many years in large part ignored the control function of accounting. In this respect, I think we have failed to give our clients all the service they have needed that we might have performed sucessfully for them. However, I hope that the current interest in management services will lead us back into much more activity in the area of management controls and accounting for managerial purposes.

There are a number of men in our profession who feel that activity in management services will lead us into all sorts of work not related to accounting. They have seen such techniques as time study and job evaluation mentioned as possible management services by CPAs. They claim that such services are not part of accounting, that we are not qualified as a profession to perform them, and that such services should not be part of the services of a firm of CPAs. Now it seems to me that this line of reasoning, while it has merit and sounds logical, would lead us to the conclusion that our professional work should be restricted to matters of financial reporting, and I personally am not prepared to accept such a conclusion. There are many methods and techniques besides accounting needed for management control, and if I am going to advise and assist clients in matters of management control, I want to know about these other principles, methods and techniques.

Now the requirements of accounting for managerial purposes as contrasted with those of accounting for reporting to outsiders are in a number of respects quite different. The kind of information management itself needs is much more specific and detailed, and it must be accumulated and reported upon much more frequently than is required for outside reporting. The accounting and related information supplied to management must be of direct assistance to management in the development of policies and in day to day control of its business.

Although accounting is an important technique to be used in enabling or assisting a management to control, we must remember that it is only a part of the whole picture and has definite limitations. In order to paint briefly a picture of where accounting does fit into the picture of management control and some of the limitations in using it, I should like to discuss briefly some of the aspects of management control which have a bearing on the place of accounting and its limitations.

The art of management consists of repeated steps of planning, organizing, acting and following up. Broadly speaking, control is making sure that actual results conform to planned results. In other words, it is the following up to see that the plans are accomplished. Although no one part of

this cycle can be disassociated from the other parts, many of the techniques with which we as CPAs are concerned tend to lie within this function of control. However, there is a lot more to effective control than just techniques. Control basically involves the measurement of actual results against some planned idea of past performance or standard. This yardstick doesn't need to be formal, calculated or exact, but it has to exist. For example, any small contractor, such as a carpenter or painter, may not know that he has standards, but he does know, when he assigns one of his men to perform a certain job, just about how long it should take that man and what the result of the job should be. To be sure he carries the information in his head based on his own past experience and judgment, but he does in effect have a standard. In fact, it is not possible to conceive of control without some sort of plan or standard.

With only a small group of men under him, a manager exercises control by direct personal observation. However, as his operation gets larger, he must select responsible individuals to assist him and delegate to them adequate authority and responsibility to carry out parts of the work. At this point the manager must start to exercise indirect supervision through his organization. When a manager can supervise personally and has the necessary experience to carry standards in his head, he doesn't need much in the way of paper work or fancy techniques or reports. In fact, he can work more effectively without them. However, when his operation becomes larger and he must depend on an organization, he must have ways of knowing performance. Accounting is one of the important ways, but the accounting must be so designed that it clearly shows performance by individual responsibilities if it is to be useful in control. This is a most important and vital factor to consider when designing either a cost accounting system or developing a plan of budgeting for a client.

Within the area of general management another important function with which accounting is indirectly concerned is that of planning and the related forecasting that must be done. As CPAs we all appreciate the importance from a financial point of view of adequate budgeting. However, planning is more than the mere projecting of the financial results of what is expected to happen. Planning also implies active efforts on the part of the management to achieve results it desires. It constantly amazes me to encounter businesses, sometimes of substantial size, that have little or nothing in the way of budgets, and I am sure there is a fertile field here for additional service for all of us.

So much for review of the background of management services and some aspects of managerial control. The final matter I would like to cover briefly is the progress we are making at the organized professional level towards assisting the profession in development of management services.

The Committee on Management Services of the American Institute of CPAs developed and has made available to the members on request a pamphlet entitled "Management Services by CPAs." Following completion of this project, the committee undertook to attempt an expansion to give a fuller description of the individual management services that CPAs ren-

der. This attempt to develop more detailed and specific material on management services by CPAs indicated clearly to the committee that further development of specific material on management services for assistance to the profession did not seem to be practical for a committee to do. It needed the continued attention of one man. Meanwhile, the interest of many members of the Institute in management services continued to develop and evidence increased that members want leadership and assistance from the Institute to guide them in this area of practice. Therefore, a year ago the late Marquis Eaton, then President, the Executive Director, and the Chairman of the Committee on Management Services by CPAs became convinced that the Institute should recognize this growing interest of members by taking action. The situation seemed to offer the Institute an opportunity to render a constructive service to the profession and to the small business community by undertaking a research project in the field of management services by CPAs with primary emphasis on the needs of local practitioners. The result was the drawing up of a proposal for such a research project in management services and approval of it by the Committee on Management Services. To quote from the proposal: "The project would be guided and defined by the following considerations and principles:

A. Local firms of CPAs and practitioners cannot normally afford the time and expense to train in the more advanced techniques of management or in the specialized services offered by many larger firms. However, it does appear practicable for local practitioners, who are willing to devote a reasonable amount of time to additional study, to acquire competence in several areas of service which are concerned with basic ingredients of effective management control, which are definitely related to accounting, and in which small businesses are deficient. Examples of such areas of service are: budgeting, use of accounting data for management purposes, cost analysis.

B. There is a vast amount of literature available on these subjects, so much, in fact, that no individual engaged in general accounting practice could find the time to review even a small part of it. Most of the literature, however, is not written from the viewpoint of the practicing CPA. Much of it is concerned with large corporation problems and does not seem readily applicable to small business. Some of this literature describes actual company situations without isolating underlying principles which might have general application. On the other hand, some of this literature is in such broad and general terms, without illustrations or examples, that it is of little practical value to a CPA confronted with a specific problem.

C. Advanced techniques of management and highly specialized services cannot be taught by the mere issuance of bulletins by the Institute. Neither can the Institute furnish "answers" to problems in management services; rather it should point out sources of information and training, principles, approaches and pitfalls.

D. In the research and in material

developed for the members, care should be taken:

1. Not to duplicate any existing literature or facilities;
2. To emphasize the danger of venturing beyond the scope of one's competence;
3. To emphasize the personal factors which must be given weight in advising any business management;
4. To make it clear that accounting can be only a part of the means of management control and to explain how each accounting service and each kind of accounting information fits into the problem of management control as a whole.

E. The research project would concern itself with uses of accounting data for management control, including budgeting and cost analysis. This field in itself covers a substantial area and there is no need to extend the research into highly specialized fields of service or into fields not related to accounting.

The broad objectives of the proposed research project are:

1. To make available to local CPAs who desire it as much as possible of the knowledge and experience of others who have made a study of the subjects under consideration;
2. To encourage, within the profession, a comprehensive, methodical approach to subjects and areas of services under consideration.

Research activities under the project would consist of the following:

A. Developing the program in detail.

B. Organizing, condensing, and presenting systematically—from the viewpoint of the practicing CPA—the best thought reflected in existing literature on the subjects covered, with emphasis on principles of general application and on sound approaches.

C. From the foregoing work, developing information, probably in the form of annotated bibliographies, as to what parts of existing literature are recommended for further study and for reference in connection with specific problems. In addition, it should be possible to identify those educational, business and professional organizations which regularly hold seminars or courses in the subjects being covered.

D. Collecting and developing illustrations and examples of services in the areas covered, drawing from actual experience of successful practitioners.''

At the meeting of Council at Phoenix, Arizona, last spring, this research project was approved and funds were appropriated to get it under way. After much searching, a suitable research assistant was engaged several weeks ago and has started to work. The Committee on Management Services by CPAs of the Institute has agreed that it will offer full cooperation to the research assistant and will be available for advice and counsel as to the program. Although the project is not an easy undertaking and I can foresee numerous difficulties in producing material that will really help local practitioners of the profession in developing management services for their clients, I am enthusiastic about it and its possibilities.

To sum up: Management services appear to be a widespread and needed activity of CPAs. AICPA and various state societies have established management service committees and at the Institute level progress is under way on material to assist the profession in developing along these lines. The profession as a whole, however, has not as yet really encompassed this field of service to clients.

Probably the best and most logical lines for the CPA to follow in developing management services are the managerial uses of accounting which would include budgeting, cost accounting, etc.

As I have indicated, what the CPA should be doing in management consulting work is basically an individual problem. However, there is one limitation on extension of our activities into management services which is most important. This limitation is that it will be dangerous to our profession, and to CPAs individually, if we undertake work which we are not competent to do under the existing circumstances. Within this limitation, each individual CPA is limited in his progress in management services only by his own and his staff's abilities, desires and initiative, and by public acceptance of his services.

PRODUCTION AND INVENTORY CONTROL

By Vance A. Wadhams

Management Advisory Services do not represent a new field of effort for the independent public accountant despite the impression to that effect which has been created by the recent emphasis on this activity. Recently there came to my attention a report issued by a New York firm of accountants in 1908—50 years ago—containing recommendations for improvements in organization structure and assignment of responsibilities, clerical and accounting procedures, cost accounting, production control, and even more surprising, suggestions for improvements of material handling methods.

The confidential relationship of the auditor with his clients provides many opportunities to learn the nature and extent of a company's problems. Working in many office departments, making plant tours, and visits to branches and engaging in discussion with employees provide an observant auditor with an insight into the need for improvements in organization and procedures. His experience will assist him to suggest practical ways of achieving these improvements. If he does not do so he is not making the most of his opportunities to provide effective service to his clients.

Two of the most important objectives of a manufacturing company are customer satisfaction and production at a cost which will assure a reasonable profit. To achieve these objectives, delivery of product conforming to specifications must be made promptly as required, and efficient use must be made of labor and capital invested in equipment and inventories. To a considerable extent, these basic requirements conflict with each other and one of the most difficult problems is the planning and control of production to achieve a proper balance between them. Therefore it is apparent that one of the most important problems encountered by a manufacturing company is that of the coordination of production with sales and inventories. How well the planning and scheduling of production is carried out may mean the difference between successful operation of the company and its ultimate failure.

Successful production control usually begins at a high level in the organization with top management making the decision as to quantities of product to make for a given or

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forecasted volume of business. Each such decision has a direct effect on operating costs and on the amount of inventory. If sales are substantially greater than anticipated, finished product inventories may be depleted to a point where orders cannot be filled, resulting in loss of sales and profit. If sales are substantially less than expected, inventories may become excessive, resulting in high carrying costs and possible obsolescence. On the other hand, if the rate of production is frequently changed to meet each minor fluctuation in sales, operating costs may become excessive. The problem is to maintain the best balance between keeping the customer satisfied and keeping the costs in line. Business involves many calculated risks and here the calculation is concerned with the extent to which a company may risk possible customer dissatisfaction in the interests of keeping costs low and the extent to which costs, such as those of carrying inventories or making short production runs, may be incurred to insure customer satisfaction. In certain types of operations there is little choice if orders are for small quantities requiring specialized manufacturing operations and few repeat orders. Under these circumstances each order may become a special production control problem.

Although in a broad sense the principles of effective production and inventory control are applicable to all manufacturers, the specific methods best suited to a particular company vary considerably depending upon the nature of its operations. In a small company the principal executive, from his personal knowledge of sales orders, production facilities and inventories, may be in a position to make the decisions for production scheduling with a minimum of records. His daily observations of work in the shop and materials on hand may be all that is required. Contrast this with the problems of planning and timing involved in scheduling work for a large automobile assembly plant where detailed arrangements must be made with company-owned plants and outside suppliers to have all required parts in specific quantities on railroad cars at various points along a route so that a freight train can be assembled and arrive at the assembly plant at the proper time. These schedules are so planned that no more than a three-day inventory of parts for assembly is on hand at any time. All of this requires plans, records and coordination far beyond the ability of one man.

One of the greatest advances made in the development of management techniques for manufacturing enterprises was the separation of the planning function from the physical execution of production. There are still a few plants in which orders are entered and then transmitted directly to the shop where foremen interpret them, requisition necessary materials, plan and execute the work. It is easy to see that even in these small plants it would be much more effective to plan production in advance, group like orders, arrange for needed materials and transmit orders to the shop only when everything is in readiness for uninterrupted production.

A brief discussion of several effective production control systems will serve to illustrate the manner in which such systems function under different operating conditions.

Consider first a company which is supplying the avionics industry,

which is in a state of constant technological advancement. This involves the manufacture of control devices which are physically small and require extremely close tolerances and precision manufacture. As the demands for missiles, rockets and aircraft to go higher, faster and farther increase, the demands for improvement in components increase. Thus the company is required to produce in small lots with very short lead times and delivery schedules and frequent engineering changes during production.

When a customer's order is received, it is posted by a member of the planning group to a production schedule board. This group estimates from flow charts of this or similar jobs the production time required for the job, consulting, when necessary, representatives of the engineering department. This production time is converted to card form on a Sched-u-graph board which shows the length of production time for each job and the total work load in the plant. A weekly summary of all jobs by type assures proper work loading in each department of the plant.

The order is reviewed by the dispatcher and work orders for each manufactured part and assembly are prepared from the parts list. Fabrication times are obtained from the production flow charts for the job and are posted to the work orders. The average fabrication and assembly time for a job is five weeks. After work orders are prepared, requisitions for purchased material are issued by the material control group to the purchasing department. All work orders are then filed by the week of release to each particular department.

A summary of all jobs scheduled for a two-month period is issued each month. The work orders are released weekly for the coming two-week period. Records of the material control department are posted from the work orders for withdrawal of material from stock. The work orders are sent to the stockroom and are used as material requisitions. They accompany the material to the specific manufacturing department where they are used by the department dispatcher for issue control. A simple dispatch peg board is used by the dispatchers for visual control of material released to the operating departments and its progress through the manufacturing processes.

The dispatcher in the department and the department foreman have authority to arrange the work assigned to the department for the week in any desired order so long as it is completed by the dates assigned from the flow chart. This allows the dispatcher and the foreman maximum flexibility consistent with schedule requirements. When production problems arise that affect schedules, the foreman and department dispatcher are responsible for working out any adjustments. If a satisfactory solution cannot be reached by them, the chief dispatcher is notified and corrective action is taken.

In effect, we have here control by exception. The control group plans the work flow and schedules it by week through the departments. The department dispatcher has complete control over specific day-to-day machine assignments within this framework. No reporting to the control group is made unless an event takes place which will affect the schedule. The completed work order for each part or assembly is forwarded to the

central group to match with the original orders in file which are then pulled and destroyed. The only posting is for the exceptions. An audit of orders by the control group on a regular sample basis assures that proper controls are being exercised.

A somewhat different system is required in the case of a home appliance manufacturer producing both for specific orders and for stock. Fabrication of the parts manufactured requires only a few days time. The major production steps consist of assembly, painting and packing. A full production cycle can be completed in one week. Long-range production requirements are established first on a basis of sales forecasts using past experience and management's judgment of future prospects. Weekly production schedules are based on specific orders and existing inventory levels reflected by the finished stock inventory records.

Bills of material are prepared, first by subassemblies, next by assemblies, and finally into completed units. At each level of the bill of material all the points of usage are noted. This provides the basis for development of requirements for orders as well as the points of common usage. Standardization of parts to the extent practicable minimizes their number and eliminates minor and unnecessary variations. Application of this procedure in this particular case reduced model variations from 1,200 to only 40 production combinations.

A combination "where used" production work sheet and material requisition form is used. On this form columns are provided for the 40 production combinations and the individual parts are listed down the left side. In each column under the appropriate combinations are noted the usage requirements. On the right hand side of the form is a tear-off section on which the combined requisition quantities are noted for each part. As orders are received from customers and work orders for stock are issued they are analyzed to determine the combinations required. The combinations are summarized for the week and these totals are then entered at the top of the form and extended for the various usages in the appropriate columns. This procedure permits an early determination of requirements and eliminates separate computation and preparation of material requisitions.

Routing sheets are used which parallel the bills of material. These sheets show for each operation, the labor hours and the material required for production of 100 pieces. Provision is made for costing the route sheets and the cost department has developed standard costs directly from these sheets.

A form similar to the one for determining material requirements is used to reflect the operating times required. This facilitates loading individual departments to their capacity to permit efficient production runs and minimize setup time.

With the exception of the analysis of orders into the 40 categories, which is performed by means of a key selection technique on a bookkeeping machine, the entire material and production control system is on a manual basis using the preprinted requisition work sheet and scheduling forms.

Inventory control of such low cost and numerous items as bolts, nuts, screws and washers is on a nonrecording basis. Under this plan minimum

quantities, sufficient for use during purchase lead time, are packaged or set aside and when needed for production, routine reorder procedures assure a new supply.

A more sophisticated type of production and inventory control system is required for a manufacturer of units which are sold to a variety of machinery producers, including automotive companies. In this case manufacturing lead times are considerably longer and various parts must be produced simultaneously. Production levels are set according to sales forecasts and contracts; minor short-term deviations are absorbed in inventories. Sales and production are plotted along with established control limits. Significant changes which fall outside the control area call for a new sales forecast and production schedule. Control limits for finished goods inventories are established, keeping production in line with sales.

Finished product requirements next are translated into specific material and labor requirements. A precise job of scheduling and material control is necessary due to the high volume and relatively few basic finished models, the integrated manufacturing processes and limited storage space.

To the extent practicable bills of material have been standardized to minimize their number, all materials have been coded numerically, and common usage of materials in various parts and subassemblies identified. Extreme care has been taken to assure that bills of material are in agreement with blueprints.

Routing sheets showing steps in the manufacturing process, subassemblies and final assemblies have been carefully checked. Decks of punched cards carrying all necessary information represent the bill of material and, by standard "explosion" procedures required quantities of parts, sub-assemblies and final assemblies are computed readily. Utilizing these figures all operations from purchase of materials through processing, subassembly, final assembly and packaging may be scheduled concurrently.

The schedule for parts and subassemblies is finally expressed in quantities to be produced each day and it backs up, step by step, from shipping and assembly requirements, to subassembly, to parts, to raw material giving due consideration to lead time in each instance.

Bills of material and route sheets are also prepared mechanically from the punched cards. Changes in the deck can be made readily by removal of superseded cards and insertion of new cards. Using these cards together with cards representing inventory quantities on hand and on order, stock status reports are prepared as required.

The procedures followed contribute toward minimizing the work in process inventory. A further aid toward minimizing inventories in this case was found in the application of advanced mathematical techniques (operations research) to major items of raw material and finished goods produced for stock. These methods involve development of a mathematical model which is based on the interrelationships among three primary costs: (1) the annual cost of carrying inventory, (2) the annual ordering or replenishment cost, and (3) the annual cost associated with actual or potential stock shortages. Under this method a plan of least cost is developed which minimizes the possibility

of excessive inventories or conversely an out-of-stock condition. Use of electronic data processing equipment is planned by this company to permit greater use of the mathematical techniques and to make possible even more rapid schedule changes.

Because so many different departments are affected, deficiencies in production and inventory control can cause trouble throughout a company with adverse effects on its progress and profitability. The need for coordination in planning and controlling production and inventories is not restricted to the large companies. Even in a small manufacturing company the personnel involved in these problems, in addition to manufacturing and production control people, include the sales and order personnel, storekeeper, purchasing agent, design engineer, process or industrial engineer, personnel director, maintenance supervisor, treasurer, traffic manager and cost accountant.

What can the independent public accountant do to aid management in improvements of production and inventory control systems? He can further his own knowledge and experience in this field and thus further qualify himself to furnish such services to his clients. He can make special reviews of production and inventory control systems and assist in the development of improved systems. If the size and type of his practice warrant he may engage experienced specialists in this field to assist him in furnishing such services. However, without becoming a specialist the independent public accountant can do much to aid his clients by being alert to the need for improvement. The evidence of inadequate production and inventory control is not confined to the production department. In the conduct of an examination of financial statements symptoms may be observed which indicate deficiencies in these functions.

Since cost accounting is closely concerned with production, the review an independent public accountant makes of a company's cost accounting and reporting procedures and inventory accounts often discloses symptoms which may indicate deficiencies in production and inventory control.* Examples of these are:

Large material usage and labor variances in cost, indicating inadequate control to performance standards.

Substantial over- or under-absorbed overhead, reflecting inefficient utilization of equipment.

Excessive inventories of raw material, work in process or finished goods, indicating ineffective production control.

Large write-downs of obsolete inventories which may have arisen from purchases or production not properly coordinated with sales requirements.

Material shortages, which indicate that production needs have not been planned properly.

Machine down time from lack of work, which may indicate inadequate planning and scheduling of production.

A review of payroll records and procedures may reflect unusual fluctuations in the labor force, indicating a need for better production planning. An excessive number of stock chasers or expeditors on the payroll usually reflects inadequate material control or production scheduling. An unusually large production control

* See the suggestive check list on the final page of this article.

PRODUCTION AND INVENTORY CONTROL CHECK LIST

Symptoms which may indicate a need for better production and inventory control	Area in which symptom may appear																		
	Accounts payable	Accounts receivable	Budgeting	Cost accounting	Financial reports	Fixed assets	Forms	General accounting procedures	Operating reports	Order billing procedures	Organization	Payroll	Purchasing	Receiving	Sales policies and procedures	Traffic	Tour of factory—inventory observation	Analysis of financial statements	
Excessive sales returns and allowances		x	x		x		x		x	x					x	x		x	
Delay in filling customer orders		x							x	x					x	x			
Promised delivery dates not met										x					x	x			
Inability to provide rush service to customers															x				
Too many back orders		x					x		x	x					x				
Excessive number of rush purchases	x			x									x	x		x			
Purchases in uneconomical quantities	x			x									x	x			x		
Fluctuations in the labor force			x	x								x							
Excessive number of stock chasers or expediters			x	x							x	x					x		
Unusually large production control staff			x	x							x	x					x		
Sizeable material usage and labor usage variances			x	x	x				x									x	
Under or over liquidation of burden			x	x	x				x									x	
Numerous hand written forms, with excessive copying of data				x			x	x				x	x				x		
Circuitous routing of production				x													x		
Excessive inventories of raw, in process or finished materials				x	x				x				x	x	x		x	x	
Material shortages				x					x			x	x				x		
Machine down time from lack of work				x					x			x					x		
Absence of accurate production information, e.g., bills of material, engineering drawings, timed operation lists				x				x									x		
New buildings or new equipment not being used				x		x											x		
Employees loafing																	x		
Production supervisors doing clerical work																	x		
Large amounts of in-process material not being worked on				x													x		
Excessive handling of materials																	x		
Excessive amounts of spoilage, scrap or rework				x					x								x		

staff may indicate that this function is not properly organized or that the possibility of mechanization of procedures has been overlooked.

Clear indications of need for improvement in production planning and inventory control which may be observed in reviewing sales order, billing, and accounts receivable procedures include excessive sales returns and allowances, delay in filling orders, inability to provide rush service to customers and numerous back orders. In addition to customer dissatisfaction these lead to excessive clerical and accounting costs.

A review of purchasing procedures and accounts payable may disclose an excessive number of rush purchases, or purchases in quantities which do not appear to be economical. These too point to a need for improved planning of production and inventories.

When symptoms are encountered which indicate that production or inventory control may be deficient, the circumstances must be examined carefully and all facts ascertained before any recommendations are made to the client. Upon closer scrutiny you may conclude that production control is satisfactory but something else is causing the trouble, such as a lack of adequate communication, ineffective quality control, inadequate material handling or inefficient control of operator performance.

This area of service to management is only one of many in which independent public accountants can furnish helpful assistance to their clients. New methods, equipment and techniques are being developed at an accelerated pace. Keeping abreast of these developments is both a challenge to our profession and a very real opportunity to further the progress of American industry by aiding our clients to find the most effective and efficient systems and procedures.

PRICING PRODUCTS FOR MAXIMUM PROFITS

By Bertrand J. Belda

There are few areas of business activity that are more significant to success than product pricing. At the same time, it appears that there is no business problem that involves so many variables or poses so many imponderables as pricing policy and practice. Without attempting to examine into the details of all the factors that bear upon this subject, I should like to discuss what I consider to be the three most important areas. These are market analysis, costs, and mark-up.

In a free, capitalistic society, prices have been traditionally established on the basis of the economic law of supply and demand. This fundamental concept is, of course, not particularly profound, but it is sometimes overlooked in the approach to pricing that is attempted by some accountants and other businessmen who attempt to establish a simple, all-purpose formula for price setting purposes. Prices for goods and services are, in other words, largely dependent upon the competitive conditions that prevail at the particular time these goods and services are offered in the market. However the impact of these intangibles and their relationship to pricing may not always be readily comprehended or interpreted. It is, therefore, appropriate to begin this discussion with a brief review of some of the principal factors that, from a product pricing standpoint, relate to supply and demand and to competition.

At the outset, it is apparent that these elements (sometimes referred to as basic market factors), while present to some extent in substantially all instances, take somewhat different degrees of emphasis for varying groups of products. The consumer durable goods group, for example, seems to be much more sensitive to customer preferences based upon style, brand consciousness, and certain aesthetic features than are those products produced and sold primarily to industrial users. Although the apparatus and industrial equipment manufacturer may experience a relatively strong measure of price competition for his finished units, once the unit is sold and installed he can often enjoy a near-monopoly market for certain replacement parts.

In pricing consumer products studies of consumer motivation and inquiries into the utility and applica-

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on of the item are usually essential optimum profits. For example, it as been a common practice to pro- de for better percentage mark-ups n deluxe models of automobiles and pplicances than on the stripped- own, standard products. Attach- ents and accessories which con- ribute to eye appeal and utility, or e necessary for the particular cus- mer's purpose, can also be priced at vels considerably higher in relation cost than the basic models. Then, o, some products, such as perfumes, rtain cosmetics, and similar items at are being distributed to the xury market, must be priced high ough to assure the patronage of e discriminating customer who is e sales target.

In reviewing the aspects of compe- ion and its relation to prices, it is portant also to note the broader plications of the problem which ust recognize that the utility and peal of almost any given product competing not only against similar oducts but against seemingly dis- nilar items as well. In the con- mer market, for example, the shing machine producer may com- te with other types of domestic plicances for the available con- mer dollar in addition to washing achines of other makes. The forge p competes with the foundry and mping plant as well as with other rging producers. The steel mill st reckon with the price of alumi- m when establishing its pattern of oduct charges or it may lose busi- ss to this alternative metal.

These areas of competition demand se attention and analysis before icing patterns can be established on basis that will provide an oppor- nity for maximum profits. Statis- tical data assembled through a sound and carefully planned market analysis can often contribute effectively to the industry and to the customer knowledge that is paramount to profitable pricing. In this connection, I think it may be appropriate to mention that the techniques of market research have many features that are similar to modern auditing procedures. The analysis of a marketing problem and its solution are usually based upon a careful segregation of the various elements into logical segments that can be examined, compared, and weighed against other known situations in order to determine the degree of meaningful relationships that may be present. Such analysis normally includes an estimate of the current and potential users of the product, the frequency of consumption, the utility in comparison with other related products, and the qualities in relation to competitive items. Also it is customary to review and appraise factors of service, delivery, and other distributive and merchandising elements. These factual data and interpretative opinions can be organized and evaluated in relation to competitive products in a fashion that can provide a valuable appraisal of the worth of the item on the market. Procedures like these are not unlike the approach to an audit of the financial statements which involves the separate step-by-step review of cash, receivables, inventories, payables, and the like as the means of appraising the soundness of the balance sheet. In addition, market analysis often involves an objective and well-conceived sampling of distributors, consumers and other areas related to sales channels as a means of validating other analytical data. This,

of course, is comparable to the test checking frequently employed by the independent auditor.

The first step toward pricing, therefore, is to make a thorough analysis of supply and demand, which involves researching the market relating to the product or product line in question. This contemplates a study of consumer need, competitive items, methods of distribution, and an appraisal of all significant economic factors affecting the establishment of price.

An important essential to the establishment of a successful pricing program is the fixing of responsibility. In many organizations, pricing policies and techniques are second to none in importance. While ultimate responsibility for pricing should be with the director of marketing, the role of the controller is also important and, as a practical matter, these two officials should work in conjunction with one another in the pricing area.

It will be noted that I have not yet discussed cost as a factor in establishing price. This has been deliberate because, too often, cost has been overemphasized, and has been used as the sole basis for pricing purposes. Let me re-emphasize that the first step is to consider the marketing aspects as I have described.

However cost is a major factor that can and should contribute to successful pricing techniques. How it should be determined, and the significance of its various elements is the next step in pricing for maximum profits.

With the increased interest in cost accounting as a means of providing better methods of operating controls and improved inventory valuations, as well as for pricing purposes, more sophisticated concepts have evolve in recent years that should be mo helpful. Probably the most signi cant of these developments has be the wider recognition of behavi tendencies in costs, and an improv understanding of the impact of the factors on pricing formulae.

When I speak of behavior ten encies in costs I am referring, course, to the variable and fixed el ments usually included in overhea Although costing for government co tract purposes usually involves calc lations that require allocation of tot costs and expenses to particular pro ucts, this technique can sometimes very misleading when utilized f commercial product pricing.

I believe that it is generally reco nized that profits, maximum profi are the result of a combination product prices and sales volume, well as costs and expenses. Also, un sales volumes are, in part, depende upon the sales prices. Because of t fixed and variable tendencies of co and expenses, it is entirely possible obtain a better dollar profit at a low unit selling price if the volume fact can be increased as a result of a pri reduction. The degree of extent which price and volume elements r late to maximum profits is depende upon the knowledge of:

1. The significance of prices as marketing factor.
2. The quantitative determination applicable variable costs.

The first of these points requires sound market analysis which I viewed briefly in the early part this discussion. The second poi that of determining the costs th vary directly with production volun is an area that I should like to explo at this time.

In most businesses engaged in the anufacture and sale of tangible oods, the elements of cost are usually gregated as between material, direct bor, and overhead. The cost of rect material and labor in any given oduct under most cost systems is dinarily not very difficult to deter-ine, and these elements usually are n important part of the variable sts which are fundamental to sound icing knowledge. The increased de-ee of automation in factories today as brought about a significant re-uction in direct labor costs, but has so resulted in an appreciable in-ease in overhead. It is in this area, erhead, that most of the problems cost accounting occur. Part of the fficulty, I believe, may be attributed the fact that accountants generally em to be most concerned over the ed to "allocate" all costs to a given oduct regardless of whether or not ch a technique is really useful. Fre-ently we find that overhead alloca-ns based upon direct labor cost ctors are from three to five times as eat as the measurable labor factor which they are applied. Further-re, an investigation into the ele-nts of overhead often discloses that e amounts of such overhead include bstantial prorates from service its which are based upon arbitrary sumptions at best.

Sound cost accounting for pricing rposes demands that the elements cost be segregated between direct d "allocated" items, as well as be-een fixed and variable elements. cordingly, it is important to pro-le adequate segregations of over-ad into cost centers in a fashion t will provide meaningful analyses the direct costs applicable to the eral basic functions that are in-ved in the production processes. Following this segregation, the various functional expense categories for each cost center should be separated into variable and fixed components in order that overhead rates can be so identified and applied in the determination of product costs. For example, if factory overhead is to be applied in relation to direct labor dollars, and the total rate is 400% of direct labor, it is important to know what portion of that rate is composed of variable elements and what portion is fixed. This can be determined by analyzing and classifying the expenses comprising the normal charges to the department.

The application of such cost data to pricing problems may be illustrated by the following hypothetical case:

> Product A is normally sold at $1.00 per unit and its current production and shipment volume is at the rate of 100,000 units per month; material, labor, and overhead costs aggregate $.90 per unit based upon conventional cost-finding methods.
>
> Assume that a market analysis indicates that sales volume could be increased by 25% if the selling price were reduced 5%, or to $.95 per unit. What are the economics of this possibility? Could we improve our profits, or would they be reduced if we made the price reduction in order to obtain increased volume? The answer depends upon the composition of the cost elements.

Assume the following unit cost elements:

Material		$.15
Direct Labor		.15
Overhead:		
Fixed	$.20	
Variable	.40	.60
Total		$.90

Applying these data to the current volume—cost experience, and to the potentional, based upon the market study, we may make the following comparison of monthly operating results:

	Present results based on 100,000 units at $1.00 each	Projected results based on 125,000 units at $.95 each
Sales	$100,000	$118,750
Cost and Expenses:		
Material ($.15 per unit)	15,000	18,750
Labor ($.15 per unit)	15,000	18,750
Variable Overhead ($.40 per unit)	40,000	50,000
Fixed Costs	20,000	20,000
Total Costs and Expenses	$ 90,000	$107,500
Profit	$ 10,000	$ 11,250

The principles illustrated here may be extended to other pricing problems, including comparisons of cost-selling price relationships between products. While the technique shown (note that the fixed costs remain unchanged) is not unique, the impact of fixed costs included in product cost analyses without identification is, unfortunately, not always recognized by price analysts. It would appear evident that there is considerable danger of erroneous conclusions unless the fixed cost elements are known.

In considering the application of this example, I should like to stress the fact that price reductions of this type must be very carefully analyzed to make certain that they will not provoke undesirable consequences. If a competitive purpose is involved, it is important to avoid the possibility of undermining the market to the point that price cuts are stimulated throughout the industry in a fashion that serves only to reduce revenues without improving volume.

Costs used for pricing purpos must be current, and to the exte possible, provide for future anti pated changes. For example, in es mating the material cost under contemplated long term constructi project, it would appear rather sh sighted to ignore the probable pri trend of structural steel over t next few years. These costs should based upon the specifications for t product and should include the n mal quantitative amounts of materi labor and variable overhead, bas upon sound engineering studies requirements, including normal wa and loss incident to manufacturi It is equally important to isol significant factors that are special unique to particular orders. Th include plant rearrangement, init tests and inspection and set-up cos

It should be apparent that the d terminations of appropriate nor for costs and the identification fixed and variable elements as I ha suggested are hardly possible to a complish with any cost system oth than a standard cost program in grated with the general accounti system. Generally speaking, the j lot method of cost accumulati simply does not provide adequate c

formation to permit sound analyses r intelligent pricing. Incidentally, nother advantage to be derived from entification of expenses into fixed d variable categories, and the estab-hment of overhead factors which ovide such separation, is the contri-ution to operating control oppor-nities. Such data can materially sist in the analysis of variances so at the impact of changing volume n be ascertained and separated from ose variations relating to operating fectiveness.

Before I venture further into this scussion of pricing of products util-ng cost information, I think it im-rtant to emphasize that cost data r pricing in a particular business is valid factor only to the extent that may approximate costs of its com-titors. Obviously, if the methods of anufacture and distribution of a ven enterprise are substantially fferent from other organizations oducing and selling comparable oducts, the market price will un-ubtedly be influenced by the re-lting cost variations.

Once we have meaningful cost in-rmation concerning a particular oduct, the next step is to apply this pricing. This means that we must nsider the amount to be added to e cost to produce a price that will, turn, be most profitable. I have ready illustrated how volume can considered in relation to costs when ices have been carefully researched. owever, most businesses need cer-in basic techniques that will provide generally reliable guide to pricing, pecially in those organizations that not produce proprietary products. rge shops, foundries, stamping ants and similar organizations that anufacture to customer specifica-tions must compete on a price basis that is responsive to day-to-day bidding requirements, and this situation demands a simple, practical technique involving cost-plus pricing.

Obviously, consideration must be given first to specific product costs. The mark-up beyond such basic costs should make provision for indirect costs and profit in a manner that will provide a price that will be competitive and will yield maximum profits. How can this be done?

At the outset, I think it important to re-emphasize the fundamental objective of industrial enterprise: TO MAKE A PROFIT ON ITS INVESTMENT. With this point in mind, it would seem that the turnover rate of the investment can provide a key to successful pricing formulae.

I believe that the concept of providing for increased margins on products that require more extensive conversion efforts is quite generally recognized. In fact, this principle is frequently introduced in price negotiations under government contracts and is sometimes referred to as the "disproportionate cost theory" or the "value added" concept. While it is not difficult to understand that a product having 90% conversion cost and 10% material cost should be priced to yield a higher mark-up than a product having reverse proportions of cost components, to devise a sound formula for this purpose is a matter that is frequently difficult to establish.

Investment turnover, when considered in connection with applicable operating costs, in my judgment provides the most useful basis for computing an equitable profit mark-up factor which, in a relatively free market, can be most responsive to the fundamental aims of the business.

Perhaps the easiest way to explain this is to utilize an example.

Assume the following facts:

Net worth of business		$1,000,000
Net current assets		600,000
Plant investment		400,000
Planned objectives:		
Annual sales		$6,000,000
Specific product costs:		
Material	$2,100,000	
Conversion and commercial	2,400,000	4,500,000
Margin for general expenses and profit		$1,500,000
General expenses (factory and commercial)		500,000
Profit before taxes		$1,000,000

The profit objective of $1,000,000 represents a goal of 100% on the investment. To this amount we must add the general expenses of $500,000 which must be covered, making a total of $1,500,000 margin over specific product costs that must be recovered in order to attain the planned return. Inasmuch as the total net worth of $1,000,000 is comprised of 40% plant investment that is needed to support the conversion effort, it follows that 40% of the desired dollar margin should be derived from the conversion effort. 40% of $1,500,000 equals $600,000 and this, in turn, is 25% of the conversion cost. ($600,000 ÷ $2,400,000). Accordingly, it would be appropriate to mark up the conversion cost by 25% in the pricing formula.

Since $600,000 of the margin objective is to be derived from facilities investment, the balance of $900,000 must be obtained from the investment in working capital. It will be observed that this remainder is equal to 150% of the working capital; however, since the working capital turnover, in relation to specific product cost of sales is 7½ times ($4,500,000 ÷ $600,000), we need recover only 20% of such cost on each turn (150% ÷ 7½). Accordingly, our normal pricing formula will include the application of 20% mark-up on total specific product cost.

Our two mark-up factors, 25% of specific conversion cost—plus 20% on total cost, provide us with a pricing formula that should give adequate and equitable recognition to the respective investment elements involved in production and sale. The application of the formula is illustrated below:

	Product B	Product C
Specific cost per unit		
Material	$1.00	$5.00
Conversion and commercial	$5.00	$1.00
Total specific cost	$6.00	$6.00
Mark-up:		
25% of conversion cost	1.25	.25
20% of total cost	1.20	1.20
Calculated Unit Price	$8.45	$7.45

As will be noted from this example Product B is to be priced, under the formula, at $1.00 per unit more than Product C, notwithstanding the fact that the total cost of each is the same. In addition to giving effect to the relative capital investment required to produce the respective products the formula gives collateral recogni

on to the degree of facility utilization involved by placing a greater weight on conversion cost in the mark-up calculation.

Please take particular note that the mark-up or profit factor has been computed on the basis of specific product costs applicable to the product. Now, for this purpose, specific product cost includes direct commercial expenses and certain fixed charges (computed at normal volume levels) such as salesmen's commissions, depreciation of equipment, supervision and similar items which do not generally vary with activity levels. These specific costs are distinguished from the variable costs that are used in computing profit behavior in forecasting or studying the impact of changing volumes.

I should like to emphasize again that formulae of this type are simply guides to pricing that should be helpful to maximizing profits through objective analysis of the factors affecting price. While this approach is more likely to be responsive to competitive conditions than ordinary cost-plus calculations, it should be obvious that no such formula can be universally applicable, and modifications to meet conditions peculiar to the trade, product, or the times are frequently necessary.

In summary, pricing products for maximum profits must take into account three fundamental factors: Careful market analysis, sound costs, and mark-up techniques that are based upon carefully planned business objectives.

The market analysis should include a penetrating study of product and territorial potentials, competitive conditions, and customer needs and desires. Costs for pricing purposes should be based upon current and future price levels and should be determined in a manner that will separate direct variable elements from fixed charges. Finally, profit mark-ups should be calculated in a fashion that will recognize the significance of the varying investment factors involved in the production and sale of different products.

Proper attention to these matters will contribute effectively to pricing products for maximum profits.

A June Night To Remember



Here's a picture of one of the many memorable events enjoyed by members and their wives at Society annual meetings. We'll be looking for you next June 14–16 at the Edgewater Beach.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

DETERMINATION OF ACCUMULATED EARNINGS AND PROFITS

All accountants probably are aware that corporate distributions are taxable to the shareholders if the distributions are from the current year's earnings and profits, or from earnings and profits accumulated since February 28, 1913. However, this whole area, and particularly, "accumulated earnings and profits" is a rather nebulous no-man's land somewhere between accounting earned surplus and a cumulative taxable income figure.

It is an area about which most tax men have some broad general concepts, but relatively few have any real definitive ideas. In fact, the textbooks, the tax services, and the courts "define" the term by stating what it is not. "The earnings and profits of a distributing corporation are not the same as net income or taxable income."[1] "But 'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts either."[2] "Taxable net income and earnings and profits are not synonymous."[3] Negative definitions are not unusual in income tax, but in this case the ruling out of accounting earned surplus and taxable income leaves the taxpayer with very little in the way of a positive idea of what should be included in accumulated earnings and profits. However, when it is necessary to compute accumulated earnings and profits, one no longer can deal in negatives or generalities, but positive decisions must be made about many specific items.

Need for Determining Accumulated Earnings and Profits

Most accountants may think that this is a problem that will never concern them seriously. This is by no means a safe assumption. An examination of any of the dividend reporting services reveals that a great many corporations reported all or a portion of their 1957 dividends to be tax-free, and it is very likely that many others declared tax-free dividends without being aware of it and without their shareholders getting the tax benefits therefrom. It would behoove all accountants to reexamine their thinking in this area, and to study their clients' or their company's historical development to determine if any of them have reached, or are approaching, a position of negative accumulated earnings and profits.

[1] Commerce Clearing House, Inc., *Federal Tax Course*, 1959, page 67.
[2] Commissioner v. Wheeler, 324 U. S. 542
[3] R. M. Weyerhauser, 33 BTA 594.

DONALD H. SKADDEN, who is an Associate Professor of Accountancy at the University of Illinois, prepared the comments for this issue.

Utilities and the extractive industries are the ones usually thought of in connection with earnings and profits studies. Certainly any company in either of these areas needs reexamination periodically, but there are also situations which call for study of any type of corporation. For example, any company which has used the rapid amortization of emergency facilities (or grain facilities), or the declining balance type of depreciation for tax purposes but not for book purposes may find accumulated earnings and profits rapidly dwindling.

Also, any company that eliminated a book deficit through a quasi-reorganization at any time in the past must continually recognize that accumulated earnings and profits are probably substantially smaller than book earned surplus. Conversely, of course, companies that have capitalized earnings in the past likely will find that accumulated earnings and profits now exceed book earned surplus.

Any company that was formed from a predecessor corporation, or that has merged with other corporations, should examine the earnings and profits histories of those other companies. It is not safe to assume that a book surplus or book deficit was the true measure of accumulated earnings and profits.

Any company that follows a practice of distributing to shareholders a substantial part of book income each year should examine accumulated earnings and profits carefully. Particularly would this be true if 1957 or 1958 happen to be loss years. A closely held corporation should reexamine its accumulated earnings and profits position as it considers the advisability of electing under the new Subchapter S not to be subject to the corporation tax.

Methods of Computing Accumulated Earnings and Profits

After a company recognizes the desirability of determining accumulated earnings and profits, there are often many questions as to methods of approach and sources of information. In many cases a logical and expeditious approach is first to compute the current balance of accumulated earnings and profits from the current balance of book earned surplus. After this "reconcilement" is completed it often will be necessary to compute the balance at the close of each year. The reconciliation as of the current date will, of course, require a detailed analysis of each year since incorporation or since the last such reconciliation was made. Thus a detailed examination of all past years is always necessary, and frequently a detailed computation for each past year is desirable, nevertheless it is often more logical to reconcile the current figures and work back rather than to reconcile each year chronologically. This is true because some transactions may have a retroactive effect upon earnings and profits. Also, some items may offset each other as between years and each reconciliation is simplified by first understanding the total historical picture.

Sources of Information Needed For the Reconciliation

Due to the fact that most of the reconciling items will be items that have been treated differently on the books than for tax purposes, the most

important source of data usually is the Schedule M from all previous tax returns. This is not to say that all Schedule M items will be used in the reconciliation, nor that all reconciling items will appear on Schedule M; however, this is probably the most important single source of information. Some Schedule M items, such as dividend distributions, and net capital losses, will not appear in a reconciliation of book earned surplus to accumulated earnings and profits because they are proper deductions in computing both figures.

Federal income taxes also are properly subtracted in arriving at both earned surplus and accumulated earnings and profits. However, there still may be a reconciling amount there because the tax figure shown on Schedule M (and subtracted from earned surplus) often includes the usual "cushion" which is not a proper decrease in accumulated earnings and profits. Also, it is important to remember that subsequently determined deficiencies or overpayments affect accumulated earnings and profits retroactively.[4] Thus it usually will be necessary to analyze the tax accrual account, and often each payment will need to be traced to the supporting tax return. Also revenue agents' reports will supply useful information concerning the nature of, and reasons for, changes in reported taxable income. This information is often valuable in determining the proper earnings and profits treatment of those items even though such treatment may not be the same as for taxable income.

All net worth accounts should be examined in connection with the computation of accumulated earnings and profits. Certain non-taxable income and non-deductible expense items are nevertheless proper increases or decreases in earnings and profits. If such an item were entered directly to a surplus reserve account, or to a paid-in surplus account, it would not appear on Schedule M, but would still be a necessary item in reconciling from earned surplus to accumulated earnings and profits. Direct entries to earned surplus should be examined in order to determine the correct earnings and profits treatment for each item.

Thus, in any computation of accumulated earnings and profits it is necessary to examine Schedule M of the form 1120, revenue agents' reports, the federal income tax accrual, net worth reserves, paid-in and capital surplus accounts, and the earned surplus account. Each particular situation should be examined closely to determine what other sources of information might be valuable. In some cases statements or reports prepared for the S.E.C. or for any of the regulatory commissions might contain information useful to such a study. As was indicated previously, it may be necessary to examine reports and records of predecessor or merged companies.

Treatment of Specific Items

Any study of earnings and profits must finally resolve itself into an examination of many specific items. Each of these items must be analyzed as to book treatment, tax treatment, and its proper effect upon earnings and profits in order to determine whether or not it should be included as a reconciling item between earned surplus and accumulated earnings

[4] Stern Bros. & Co., 16 TC 295; Estate of Esther M. Stein, 25 TC 940 (acq.).

and profits. The proper treatment of many items will be quite clear and self-evident. The code and regulations indicate the proper handling of some items. Others have been covered in various court cases. In many situations there will be some items that have not been decided by the courts nor discussed in the literature. The following sections are concerned with a few of the specific items that are treated in the Code, regulations, or court cases. A study of these items should be helpful in analyzing others that are not found in these sources.

(1) *Dividend distributions*

Probably no one would question the fact that dividends properly reduce accumulated earnings and profits. There may be some questions, however, as to the timing of the reduction and also as to the amount of reduction in the case of non-cash dividends. The code and regulations are rather specific on the second of these points, but do not help much on the first.[5] In case of scrip dividends, the code indicates that the principal amount of the obligation issued should be the charge to earnings and profits.

Property dividends normally reduce earnings and profits by an amount equal to the adjusted basis of the property distributed. Exceptions occur when inventory assets are distributed, or when the property distributed is subject to a liability. In the case of inventory distributions, earnings and profits first are increased for the excess of fair market value over adjusted basis and then reduced by the fair market value. The purpose of this is to assure that the dividend always will be taxable at least to the extent of the inventory profit. When property subject to a liability is distributed the reduction in earnings and profits is the adjusted basis minus the liability and plus any gain recognized.

Stock dividends and stock splits, while they may reduce earned surplus, have no effect on earnings and profits.[6] These and other book transfers of earned surplus, such as transfers to surplus reserves, can cause some of the larger differences between earned surplus and accumulated earnings and profits.

The timing of the reduction, as between the date of declaration, date of record, or date of payment, is not established by the code and regulations. Also the court decisions are not in complete agreement on this point. The date of declaration was held to be the significant date in *Commissioner* v. *Goldwyn*,[7] but in that situation there was constructive receipt of the dividend to the shareholders which surely had much bearing upon the decision. The present weight of authority seems to be with the Supreme Court statement in *Mason* v. *Routzahn* [8] that "... the date of payment, not the date of the declaration of the dividend is the date of distribution ...," and therefore determines the time that earnings and profits are reduced. Under this theory any final quarterly dividends, or special dividends declared at the close of a good year, may be paid during a year of low earnings or even losses, and would reduce earnings and profits in the low income year. Furthermore, in some instances, the taxability or non-taxability of such a distribution might not be determinable at the time it

[5] IRC 312 (a).

[6] F. J. Young Corporation, 35 BTA 860.

[7] Commissioner v. Goldwyn, 175 F. 2d 64.

[8] Mason v. Routzahn, 275 U. S. 175.

was paid. Section 312 of the Internal Revenue Code, (in which dividend is defined), indicates that the current year's earnings and profits are "... computed as of the close of the year without any diminution by reason of any distributions made during the taxable year. . ."

Thus, as of any given date, all dividends declared but not paid should be added back to earned surplus in reconciling to accumulated earnings and profits.

This problem of timing may take on special significance under the new election not to be taxed as a corporation. Under the Technical Amendments Act of 1958 "the accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of the shareholders. . ."[9] Therefore, if a corporation elects the new treatment for 1958 its earnings and profits will be reduced in 1958 for any 1957 dividends paid in 1958, plus all of the 1958 earnings whether or not paid out.

(2) *Federal income taxes*

As indicated above, taxes reduce earnings and profits of the year to which the tax pertains. This is true of deficiencies paid subsequently as well as taxes paid currently. However, the "cushion" in a tax accrual account is nothing more nor less than a surplus reserve as far as accumulated earnings and profits are concerned. However, it is not always safe to asume that the reconciling figure is simply the excess of the accrual balance over the tax reported on the last 1120. The accrual account should be analyzed for unusual items. One such item that may be found here is interest paid on tax deficiencies. While this interest paid is a logical reduction in earnings and profits, there is nothing to indicate that the reduction is retroactive as in the case of the deficiency itself. Interest apparently is a reduction only when paid. Thus a single charge to the accrual account may be made up of a deficiency and interest which reduce earnings and profits of two different periods. Any other unusual items that may be found in the tax accrual account must be examined in order to determine whether or not the accrual balance must be adjusted to arrive at the proper reconciling figure.

The income tax liability computed on a consolidated return must be allocated to the various members of the group. The code states that the allocation can be based on taxable incomes or on taxes computed separately, or on any other basis approved by the Commissioner.[10] Operating losses incurred by a consolidated subsidiary do not reduce earnings and profits of the parent company although they are deducted on the consolidated return. Upon the subsequent dissolution of that subsidiary, the parent's earnings and profits are reduced by the total of all prior operating losses plus any additional loss on liquidation.[11] Limitations are discussed below for the situation where the subsidiary's losses have caused a negative accumulated earnings and profits.

Also in this area of Federal income tax liability, but not in the accrual account itself, would be the so called "deferred income taxes." Although book earnings (and therefore earned

[9] IRC 1377 (a).

[10] IRC 1552 (a).

[11] Taylor-Wharton Iron and Steel Co., 5 TC 768.

surplus) are reduced currently for such deferred taxes, earnings and profits are reduced only by the amount actually due for the period. Any "deferred" balance is really just an additional "cushion" as far as accumulated earnings and profits are concerned and should be added back to earned surplus in the reconciliation.

(3) *Depreciation and depletion*

One of the frequent causes of deferred income tax is a material difference between book depreciation and tax depreciation. Whether this difference is due to tax use of one of the accelerated depreciation methods, or rapid amortization of emergency facilities,[12] or to a difference between book and tax bases of the assets, earnings and profits follow the tax deduction. Thus, the cause of the deferred income tax and the deferred tax itself are treated consistently.

Depletion, on the other hand, is one of the areas in which earnings and profits do not follow the taxable income calculation. Earnings and profits are reduced only by cost depletion. Thus, discovery value, fair market value, and percentage depletion are not proper reductions in earnings and profits.[13]

(4) *Gains and losses on sales of property*

Consistent with the above use of tax depreciation is the fact that earnings and profits are increased or decreased only by recognized gains and losses.[14] Thus, property bases are the same for earnings and profits as for taxable income. However, earnings and profits are reduced by all recognized losses even though they result in a net capital loss which is not deductible in computing taxable income.[15]

(5) *Operating losses*

There is no carry-back or carry-over of net operating losses for the purposes of computing earnings and profits. Accumulated earnings and profits are reduced at the time that a loss is incurred. Thus an operating loss can not offset future earnings unless all prior earnings and profits including those accumulated prior to March 1, 1913 are eliminated.[16]

(6) *Earnings and profits of predecessor companies*

Accumulated earnings and profits of the acquired corporation is one of several items that carry over to the acquiring corporation under I. R. C. 381 (c) (2). This is essentially a codification of the old *Sansome* rule.[17] The *Sansome* rule has always been relatively simple to apply where a new corporation simply replaces an old one that had a balance of accumulated earnings and profits. However, the courts found it necessary to modify *Sansome* where distributions were made in connection with the reorganization, and also where the predecessor companies had negative earnings and profits. In *Munter*[18] the Supreme Court ruled that if distributions related to the reorganization are taxable as dividends, then earnings and profits carried over are reduced accordingly. In *Phipps*[19] it was held that deficits

[12] IT 3543; CB 1942-1, p. 111.
[13] Regulations 1.312-6 (c) (1).
[14] IRC 312 (f).

[15] Regulations 1.312-6 (b); IT 3253, CB 1939-1, p. 178.
[16] R. M. Weyerhauser, 33 BTA 594.
[17] Commissioner v. Sansome (2 Cir. 1932), 60 F. 2d 931, cert. den. 12-9-32, reversing 22 BTA 1171.
[18] Commissioner v. Munter (1947), 331 U. S. 210, reversing (CCA-3), 157 F. 2d 132, which had reversed 5 TC 108.
[19] Commissioner v. Phipps (1949), 336 U. S. 410, reversing (CCA-10), 167 F. 2d 117, which had affirmed 8 TC 190.

of the predecessor companies did not carry over. However, *Phipps* was then modified in *Snider* [20] to the effect that deficits of the predecessor company could not offset earnings and profits of the acquiring company at the date of the merger, but could offset earnings and profits accumulated after that date. In essence, *Phipps* and *Snider* were codified in the 1954 Internal Revenue Code at Section 381 (c) (2) (B).

Sansome has also been applied in cases of divisive reorganizations as well as acquisitions. In these cases the earnings and profits of the predecessor are allocated to the successor companies.[21]

(7) *Miscellaneous items*

Tax exempt income such as state or municipal bond interest [22] or life insurance proceeds paid by reason of death [23] do increase earnings and profits although not a part of taxable income.

Many items of income or expense may receive optional treatments in the taxable income calculation. In most cases, once the option is chosen, the same treatment also must be used for earnings and profits. This is true in the depreciation area discussed above. Apparently this also would be true in the following areas:

(a) Accrual or cash bases of accounting [24]
(b) Installment sales [25]
(c) Bad debts [26]
(d) Capitalization of certain expenses during construction [27]
(e) Organization expenses
(f) Research and development expenses.

Issuance of capital stock at a premium does not create earnings and profits. Furthermore, it has been held that redemption of stock for less than the issue price also does not create earnings and profits. Such redemption discount is considered additional paid-in-capital.[28] This, of course, is consistent with general accounting treatment of these items. On the other hand, some question may arise as to premiums paid on the redemption of stock. Accounting-wise this charge is often (perhaps usually) to earned surplus, and perhaps earnings and profits should be reduced under a broad interpretation of *Weyerhauser* [29] and *Ayer*.[30]

> "Thus, under the ordinary method of accounting, in computing earnings and profits there will be deducted, not only the . . . ordinary and necessary expenses, . . . but others which are not, under the statute, deductible in computing taxable net income. In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits tending to increase the value of the property."

> ". . . corporations frequently make expenditures which are not deductible from gross income for income-tax purposes, but which nevertheless reduce earnings or profits."

The Commissioner very likely would argue that earnings and profits should not be reduced by such pre-

[20] U. S. v. Snider et al, (CCA-1, 1955), 224 F. 2d 165.
[21] Barnes v. U. S. (1938), 22 F. Supp. 282; 26 USC 312 (i); Regulations 1.312-10.
[22] Regulations 1.312-6.
[23] Regulations 1.312-6; Commissioner v. South Texas Lumber Co. (1948), 333 U. S. 496, reversing (CCA-5), 162 F. 2d 866, which had reversed 7 TC 669.
[24] Regulations 1.312-6.
[25] Rev. Rul. 54-230, CB 1954-1, p. 114.
[26] Benjamin Siegel, 29 BTA 1289.
[27] Ernest A. Jackson (1949), 172 F. 2d 605, affirming 9 TC 307.
[28] United National Corp. v. Commissioner (1944), 143 F. 2d 580, reversing 2 TC 111.
[29] R. M. Weyerhauser, 33 BTA 594.
[30] Charles F. Ayer, 12 BTA 287.

miums because they not only are not deductible in computing taxable income, but also are usually taxable to the shareholders as capital gains and not as dividends. However, if these premiums do not reduce earnings and profits they would have to be considered as a return of capital. The Securities and Exchange Commission's stand on redemption of preferred stock seems somewhat more logical. The S. E. C. holds that any excess the preferred shareholders receive over what they paid in is considered to be from earned surplus rather than from capital contributed by some other group of shareholders.

Closely related to the above area of premiums and discounts on capital stock issued or redeemed is the expense of issuing stock. Here again, no case directly on this point was found. It has been rather well settled that such expenses are not deductible in computing taxable income, but again relying upon *Weyerhauser*, these might be considered in the "extraordinary expense" category. It seems a strong case could be made that earnings and profits should be reduced to the extent that these expenses are properly charged to earned surplus on the books. Such a charge to earned surplus may be proper for (a) expenses of a going concern issuing additional stock, (b) preferred stock expenses, or (c) regulated industries where the regulating authority prescribes such a charge.

Election Not to be Taxed As A Corporation

The Technical Amendments Act of 1958 included "Special Rules Applicable to Earnings and Profits of Electing Small Business Corporations."[31] As mentioned earlier, this section provides, quite logically, that the accumulated earnings and profits of an electing small business corporation shall be reduced by those undistributed profits which the shareholders report as income. However, where the law provides for later nontaxable distribution of these profits the definition of the "shareholder's net share of undistributed taxable income" raises some question concerning the status of these undistributed profits after the corporation terminates its election and again is taxed as a corporation. His share is defined as the total of the undistributed profits included in gross income of the shareholder ". . . for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply *and all taxable years preceding such year*)"[32] reduced by his share of losses and by distributions to him from the undistributed profits on which he has already paid the tax. (Emphasis supplied.) This section could be interpreted that profits undistributed as of the date the election is terminated again become basis for taxable dividends. This undoubtedly is just one of many earnings and profits questions that will arise from this very interesting new law.

A.I.C.P.A. Recommendations

In conclusion it seems appropriate to mention briefly the recommendations in this area submitted to the Ways and Means Committee by the Committee on Federal Taxation of the American Institute of Certified Public Accountants. The major recommendation concerned Section 316 (a)

[31] IRC 1377 (a).
[32] IRC 1375 (d) (2).

(12),[33] and was to the effect that dividends out of current earnings should not be taxable until a prior deficit in accumulated earnings and profits has been eliminated. This would be a significant and very desirable step toward bringing tax accounting more into agreement with generally accepted accounting in this area, but would constitute a radical change in a long established tax policy.

[33] Committee on Federal Taxation, American Institute of Certified Public Accountants, *Recommendations for Amendments to the Internal Revenue Code*, 1958, page 20.

Section 312 (j) provides, in essence, that distributions paid out of the unused proceeds of a federally guaranteed loan shall be taxable as dividends. This is accomplished by increasing the earnings and profits by the excess of the loan over the adjusted basis of the property securing such loan. The Institute Committee recommended three changes in this section in order to (1) close an existing loop hole, (2) avoid an unintended doubling up of taxable base, and (3) clarify the intended meaning of the section.[34]

[34] *Ibid.* p. 19.

The Local Practitioner and Credit Grantors

By the Committee on Local Practitioners of the
Illinois Society of Certified Public Accountants

Much has been written and said about cooperation between certified public accountants and credit grantors. As a result of a great deal of effort on the part of both groups, much has been done to bring about a better understanding of their respective areas of responsibility in serving the business community. There have been substantial accomplishments in general areas of understanding, but specific matters appear to need further attention.

Many CPAs in local practice have expressed the conviction that relations between bankers and the smaller accounting firms need special attention. The Board of Directors of the Illinois Society of Certified Public Accountants referred this matter to the Local Practitioners Committee during the Society's 1957-58 year and a sub-committee was appointed to study the problem. The following is the report of this sub-committee, adopted by the Committee as a whole.

* * *

As the result of our study, we believe that a few simple recommendations should be made to local practitioners which, if followed, would be helpful in achieving and maintaining the desired relationship with bankers and other credit grantors. These recommendations are as follows:

1. Review your files to determine which banks or other credit sources your clients use.
2. Decide which of these organizations you would like to work with more closely.
3. Be sure you have done a good job of auditing and of reporting your findings.
4. Contact loan officers and ask for appointments for the purpose of determining what they like to see in audit reports submitted to them.
5. Follow up with subsequent visits until closer personal relationships have been developed.

At the beginning of our study, we decided that we wanted information which would give us a realistic evaluation of the situation and which would suggest methods to promote good relations. We turned to the bankers themselves for this information. We did not contact credit grantors other than bankers in our research since we assumed that their thinking is similar to that of bankers.

This article has been submitted by the Illinois Society's Committee on Local Practitioners of which ROBERT C. SASSETTI is Chairman. The sub committee referred to in the article was composed of O. ELDRED GOUGH, Chairman, CURTIS CATRON, and WILLIAM G. HILLSMAN.

We believe our recommendations apply equally to relations with them. Our entire Local Practitioners Committee was asked to attend joint meetings with personnel of two Chicago loop banks to discuss the problem. In addition to these two general meetings, and with the same purpose in mind, members of the sub-committee met individually with bankers outside of the loop area. As a result of these meetings we are convinced that, by and large, all bankers have similar attitudes toward certified public accountants, their audits, and their audit reports.

Our discussions with bankers revealed some of the reasons why certified public accountants in local practice, as a group, are not accepted by bankers on the same basis as nationally known firms. These reasons, together with certain other information emanating from the discussions, may be divided into the five general classifications discussed in the following paragraphs.

1. *Disadvantages of local certified public accountants as compared with national firms from the banker's standpoint:*
 (a) The local CPA is not always known to bankers and other credit grantors.
 (b) Banks have had or have heard of unsatisfactory experiences with work of some local practitioners, and the reputation of local practitioners as a a group has been damaged.

Comments:

The local practitioner becomes known as he performs services and renders reports to outsiders such as banks. The quality of the finished product, the report, will determine to a large extent whether becoming known is good or bad for the future of his practice. Many banks maintain files on certified public accountants who perform audits for their customers. These files contain appraisals of the quality of the accountants' reports and services. We understand that certain banks exchange information concerning accounting firms; a bank which receives a report submitted by a CPA not known to it may contact other banks to determine the extent to which it can rely on the report.

Unfortunately, some people who qualify as professional accountants in some ways may fall short in others; we must recognize the problem of substandard work. We are concerned with the fact that many local practitioners do not take part in the activities of their professional societies and thus lose the best means they have for continued professional improvement. We must use every way possible to encourage adherence to the high standards of the profession.

2. *Banker criticisms of the practices of some certified public accountants:*
 (a) There are frequent violations of Statement 23, now included in the Rules of Professional Conduct of the American Institute of Certified Public Accountants and of the Illinois Society of Certified Public Accountants.
 (b) Indications are that some CPAs render reports when they are not in fact independent.
 (c) Reporting practices are inadequate at times. (See discussion under item 3 for report practices considered desirable by bankers.)

Comments:

After ten years of constant publicity regarding Statement 23, bankers tell us that many reports still are submitted without regard for its contents. There is no reason why all certified public accountants should not follow Statement 23 in rendering reports. The requirement, in effect, is that any report submitted on the stationery of a certified public accountant should include an opinion (qualified or unqualified) or a disclaimer of an opinion together with the reason for the disclaimer.

Bankers are concerned also about independence. If there is one thing a certified public accountant in public practice must be, it is independent; if he loses his independence, he has lost his value. Perhaps in this respect local practitioners may have a bigger problem than the larger firms. There is quite often a closer personal relationship between the local practitioner and his small client than may exist between the national firm and its generally larger client. In addition, we always face a natural anxiety over the possibility of losing a good client if independence conflicts with the wishes of the client. If we are to continue to grow professionally, however, we must maintain our independence, and bankers should have no doubt concerning it.

3. *Report practices which bankers consider desirable:*

(a) The long-form report is preferred over the short-form. In addition to comments relating to procedures, the long-form report better serves the banker if it includes the following:

(1) The age of the receivables with comments as to the results of confirmations and mention of any concentration of large amounts in a limited number of accounts.

(2) The mention of any defaults on loan payments or covenants.

(3) The status of income tax returns which have not been examined, together with comments as to any material change that might result from examination of open years.

(4) Certain balance sheet ratios.

(5) A list of bank accounts maintained.

(6) Information as to inventory turn-over and comments on treatment of obsolescence.

(7) Information on investments in other companies —book value of the equity, percentage of ownership, earnings, etc.

(8) The entire "Accountants Opinion" — scope, exceptions, and opinon paragraphs — shown on one page.

(b) All reports, long or short-form, should contain the following:

(1) Comparisons of operating figures for the current period with those of the similar period for the prior year, including percentages.

(2) Certain balance sheet ratios.

(3) Application of funds statements.

Comments:

No one can deny that all of the foregoing reporting practices are desirable. From a practical standpoint, however, we must recognize that our clients, the banks' customers, are not always willing to submit all of this information.

Some of the bankers expressed the thought that a qualified condensed short-form report has little value. One bank representative indicated that he felt we lower the standards of the profession when we do not insist on performing enough work to enable us to render an unqualified opinion. Banks can, and often do, assist us in convincing clients that our examinations should be of sufficient scope to permit expression of an opinion. Obviously much can be done by both bankers and CPAs in this area. Some bankers indicated that they may charge lower interest rates to borrowers who submit long-form, unqualified reports prepared by reliable CPA firms, and all bankers look with favor on such reports. Our clients should be informed of advantages to be gained by full cooperation with their banks.

4. *Practice of banks in recommending accountants to their customers:*

 (a) When asked by customers for recommendations, the banks usually submit the names of from three to five firms of certified public accountants.

 (b) Preference is naturally given to CPA firms who are themselves customers of the banks. This does not mean, however, that all other CPAs are excluded.

 (c) Preferential consideration is often given to CPAs specializing in certain industries.

 (d) The banks recommend CPAs whose work is familiar to them and who may be relied upon to do a good job of auditing and of reporting their findings.

 (e) Some bankers are of the opinion that small businesses may be better served by small CPA firms, medium sized businesses by medium sized CPA firms, and so on; this is a consideration in making recommendations.

 (f) Representatives of the banks stated that they do not recommend changes of auditors to their customers unless there is good reason for doing so.

5. *Specific suggestions made by bankers as to ways in which personal relationship may be improved between local certified public accountants and bankers:*

 (a) Get better acquainted with the bankers with whom clients do business.

 (b) Suggest that clients go to their banks with you to find out what the bankers want in reports. CPAs who suggest such meetings are looked upon with favor by banks.

 (c) Arrange meetings which would be attended by both CPAs and bankers for the express purpose of exchanging ideas on improving relationships.

Comments:

It was brought out in our meetings that bankers are as anxious to know us better as we are to know them. Without exception, the bankers we talked with gave their fullest cooperation in attempting to develop methods to improve our relationships. In view of the helpful discussions which we

have had, we believe that similar meetings on a larger scale should be considered. We have information that such meetings have been conducted successfully in other areas.

Conclusion

We have attempted to outline as much of the information obtained as possible. If the points discussed appear to be of a negative nature, we believe that they suggest a need for positive action on the part of the local practitioner. We believe it is clear that all local practitioners who are interested in developing better relationships with banks and other credit grantors must first of all:

(a) Remain unquestionably independent.
(b) Follow generally accepted auditing standards in performing all audit assignments.
(c) Prepare audit reports tailor-made for each assignment and follow Statement 23 in every case.

Having complied with the foregoing basic rules of practice, the local practitioner should follow the recommendations set forth at the beginning of this report to establish a relationship with bankers and other credit grantors which will lead to better service for clients and better appreciation of the service which can be rendered by the local practitioner.

AUDITS OF EMPLOYEES' CREDIT UNIONS

By Peter H. Burgher

Employees' credit unions represent a type of savings-finance institution that is enjoying increased popularity and, in many instances, is achieving notable success in the attainment of its objectives. A credit union is composed of members who are all common to one employer.[1] The objectives of employees' credit unions are twofold. They serve as a depository of savings funds collected primarily by means of payroll deductions made through an employer's payroll. These deposits are referred to as the members' "share accounts" and are similar to savings and loan associations' shares in the sense that the members share in the ownership of the institution through their deposits. Equal in importance is the service these institutions provide in supplying small loans to their members. The employer often gains substantial benefits from a credit union because of the effect on his employees' morale of the opportunity to save with the relatively high rates of return on these savings that a credit union can usually offer. A corollary benefit results from the employees' opportunity to borrow for worthwhile purposes at interest costs comparable to the lowest rates obtainable elsewhere.

[1] Although credit unions may be formed by any group of people with a common interest, this article will deal with those institutions based on a group common to one employer which constitute the majority of present day credit unions.

Organization

There is a close relationship between the employer and the credit union due to the fact that all the members are common to the one employer and that the employer renders certain services to the credit union. For this reason, any difficulty encountered by the credit union is often regarded by the employees as the employer's responsibility. Therefore, the employer has both a moral and financial responsibility to the members of the credit union.

A credit union is different from thrift plans or savings-stock purchase plans in that it is a self-governing entity apart from the employer's organization. The employer contributes to the credit union to the extent that quarters may be provided rent-free or employees directed to work for the credit union for which no charge is made by the employer. The employer provides quasi-financial resources by making payroll deductions and remitting these funds to the credit union.

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At an annual meeting the members elect a board of directors who, in turn, appoint officers responsible for the management of the credit union. A supervisory committee and a credit committee are also elected by the members annually. The treasurer generally administers the credit union's affairs and supervises the operating personnel. The supervisory committee is responsible for the direct supervision of the operations as performed by the treasurer and other employees as well as performing audits as required under the banking laws. The supervisory committee provides a method whereby the members' interests are continually protected. The credit committee reviews and passes upon loan requests submitted to the credit union.

Regulation

Credit unions may be organized and granted charters under either Federal or State laws. The laws referred to are generally similar in content and, under both Federal and State supervision, audits are required at regular intervals. Furthermore, credit unions are subject to examination by examiners under the direction of the governmental bureau or department whose responsibility it is to supervise the particular institution.

It is generally recognized that audits by independent public accountants are not designed to detect or prevent (specifically) any defalcations or frauds of immaterial amount.[2] Similarly, an examination by Federal or State bank examiners is not designed to disclose fraud. This is forcibly brought out in a recent Maryland case where substantial defalcations had been achieved over the course of several years and the Credit Union sought, unsuccessfully, to hold the Federal bank examiners responsible.[3] Such examinations as may be made at the discretion of the responsible Federal or State officials are designed to supply the officials with information necessary for them to exercise properly their regulatory functions. The detection of fraud and the verification of accounts are not the primary functions of such examinations.[4]

The outside auditors of a credit union, as stated in the procedures listed below, should determine that the recommendations of the examiners are being followed. The principal features of examiners' reports usually deal with specific infractions of law or approved procedure, and differences found in relating the various subsidiary ledgers and accounts to the general ledger. Little outside verification is made by examiners for regulatory agencies. The independent public accountants should, therefore, place reliance upon the examinations made by Federal or State examiners only to the extent their examination is explained above and the procedures followed may be specified in their reports.

Audit Procedures

The audit of a credit union involves the usual concepts of tests of operations, income and expenses, and the verification of balance sheet accounts. In addition, due to the fact that credit unions are supervised by regulatory authorities and are governed by banking laws, there are certain audit pro-

[2] General reference—Levy, *Accountants' Legal Responsibility*, p. 13.

[3] Social Security Administration Baltimore Federal Credit Union, and Liberty Mutual Insurance Company v. United States of America, U. S. District Court for the District of Maryland, Civil No. 7191.

[4] *Ibid*, also *The Development of Bank Supervision in The United States*, 1949, Federal Deposit Insurance Corp., p. 48.

cedures that are specifically required to meet these laws. Certain specific requirements under New York law will be mentioned in the procedures listed below. It may be assumed that these are reasonably typical of the requirements in other states. It should be noted that New York law requires annual audits to be performed by the supervisory committee,[5] but for purposes of discussion it will be assumed that independent public accountants are making the audit for the committee as is allowed with permission of The State Banking Department.

A review of internal control should be an integral part of the audit program. Any deficiencies in internal control should be noted and audit procedures expanded accordingly. Recommendations on internal control should be made to the supervisory committee and should be followed through to make sure that the defects are remedied. In this connection, periodic vacations for credit union personnel are a matter of necessity. The auditor should satisfy himself that vacations have actually been taken by all officials and employees and that they have been of sufficient length. The purpose of this procedure is to expose each employee's work to another person and prevent continual personal control over any funds or accounts. This interruption will help prevent defalcations.

The following are suggested specific procedures that may be adapted to the particular credit union under audit:

1. Confirm individual members' loan accounts and members' deposits or "share accounts" and tie totals to the general ledger.
2. Confirm all other accounts receivable of material amount, and analyze accounts.
3. Confirm with borrowers all securities held as collateral. Count all such securities on hand.
4. Confirm all bank balances and reconcile the amounts reported by the banks to the balances shown on the books.
5. List all securities owned by the credit union and support changes in holdings by examination of brokers' advices, etc. Confirm securities held by others and count all securities on hand. See that all securities owned fall within those permitted by law. The banking laws require that credit union investments conform generally to those securities permitted as investments for savings banks.[6]
6. Analyze prepaid expenses and support the amounts recorded by means of examination of original papers, invoices, etc., and make sure that their amortization or write-off is correctly computed.
7. Prepare a schedule of fixed assets, and their changes. Support, by appropriate tests, the costs of additions, and the correctness of amounts of retirements.
8. Analyze accumulated depreciation, determine that the provision for the period under audit is correctly computed.
9. Analyze accounts payable and make a search for material unrecorded liabilities.
10. Analyze expense accounts and examine supporting papers and documents for material items.
11. Count petty cash and funds on hand on a surprise basis; tie balances to the general ledger and trace transactions in petty cash not cleared out as of the count to

[5] New York State Banking Law, Art. XI Sec. 71, 2, d.

[6] *Ibid* Sec. 456 and Sec. 453.

subsequent entry to the appropriate accounts. Determine that funds awaiting deposit are deposited promptly.

12. Review employees' loan accounts to see that they are current, that deductions or payments are in proper amount as evidenced by the notes made by the borrowers, and that the balances agree with the amounts included in the general ledger totals. It is also appropriate to refer to the employers' payroll records on a test basis to ensure that the persons to whom loans are granted are bona-fide employees and members of the credit union.
13. Independently obtain the details of payroll deductions submitted by the employer and by means of tests determine that deductions are made in the proper amount and are correctly reflected in the respective loan or "share" accounts. Check that the total of such deductions agrees with the amounts recorded in the control accounts.
14. Test cash disbursements to ascertain that disbursements are supported by properly completed, signed, and approved loan applications and notes, share withdrawal requests, or expense vouchers, and that the transactions are properly reflected in the individual employees' accounts or other appropriate accounts. Trace the total amounts of such transactions to the respective control account postings.
15. Analyze the required "reserve" for bad debts and see that the balance is in accordance with the Law which requires given provisions to be made for loans in various categories of age past due.[7] Support receipt of cash on recoveries of debts previously written off and trace delinquent loans to a record of delinquent accounts upon which the "reserve" is based. Determine that adequate attention is given to the collection of past due loans.
16. Verify that the income earned from securities investments, savings deposits, and other non-loan sources is properly recognized by means of independent calculations and reference to published dividend records, etc.
17. Trace the interest on loans granted during the period to interest income and unearned interest, if any, paying special attention to the consistent application of principles of amortization of unearned interest if the institution grants loans on a discount basis. Determine that interest is properly charged on new and refinanced loans as regards individual borrowers' accounts.
18. Test the computation of dividends paid or payable on share balances and determine that dividends are correctly posted to individual employees' accounts and are in accordance with the law which sets up limitations to dividends based on earnings and undistributed earnings.[8]
19. Analyze undistributed earnings (i.e., earned surplus).
20. Analyze surplus (i.e., reserve for contingencies) and ascertain that changes are in accordance with the law in that, among other things, at least 20% of earnings are credited to surplus, until certain conditions are met, all entrance

[7] *Ibid* Sec. 458.
[8] *Ibid* Sec. 459.

fees, fines and transfer fees remaining after organization expenses are credited to surplus, any recoveries of sums previously charged to it are credited to surplus.[9]

21. Establish that no individual share accounts and no individual loan accounts of a net loan in excess of share balances exceed amounts specified by law for credit unions with various amounts of capital.[10]
22. Determine the date of the latest examination made by the State Banking Department and see that all recommendations made in the report on that examination have been given effect to by the credit union.
23. Make extracts of minutes of meetings of the board of directors, supervisory committee and credit committees (if any).
24. Prepare a report to the supervisory committee supplying information necessary for them to complete a required questionnaire on the examination for the State Banking Department. Answers to the questions will be furnished through the above procedures.

An element of surprise should be introduced into the audit program wherever possible. The application will vary according to the particular situation. Areas in which surprise may be used include petty cash and securities counts, confirmations, and payroll tests.

The auditor must be careful to exercise his responsibility to the members of the credit union as well as to the supervisory committee to whom his report is addressed. In view of the special relationship which exists between the employer and the credit union, all transactions between the employer and the credit union should be carefully observed. Furthermore, the credit policies exercised by the responsible officials of the credit union should be reviewed in general and in their application as is developed during the audit. The employer should be encouraged to take an active interest in the credit union in securing capable management and ensuring that the responsible officials properly discharge their duties.

[9] *Ibid* Sec. 457.

[10] *Ibid* Sec. 454 (various subsections).

CONFIRMATIONS

There is some variation in the required extent and type of confirmations that should be obtained on members' loan and share accounts. It is preferred by certain authorities to have positive type confirmation requests used. The extent of such confirmation contemplates that at least 100% of the members be so circulated during the course of one year. However, in one case, the state authorities have consented to negative type requests being sent for ⅓ of the members' accounts at the end of each of three quarters and 100% at the end of the other quarter in one year. This results in 200% circularization on a negative basis during any particular year. The quarter in which 100% is requested is varied from year to year.

A method used for smaller credit unions is to relate members' passbooks to their ledger cards or accounts on a random basis in lieu of mailing confirmation requests. This can be done by stationing an auditor at the collections window of the credit union for a period of several days so that he can examine the passbooks presented by the members or by examining passbooks in connection with a payroll payoff. This has the advantage of

tracing from an independent outside source to the books of record whereas mailing of confirmation requests based on ledger cards can only include those members for whom ledger cards or records are available to the auditor.

SUMMARY

From the foregoing it can be concluded that the audit of a credit union is similar to the audit of a small loan company with the major difference being the additional procedures required to determine the correctness of the balances on deposit as shares of the members. The specific techniques required to accomplish the procedures outlined above will vary according to the accounting system maintained by the credit union. Machine accounting systems are particularly applicable to credit unions' use (especially where the payrolls of the employers are similarly prepared) due to the many small transactions and accounts involved and the homogeneity of the items encountered. Savings in audit time can be accomplished by intelligent adoption of certain techniques available through the control over this type of accounting that an auditor can exercise. For example, confirmation requests can be prepared under the control of the auditor on punched card equipment in a fraction of the time required for manual preparation. A number of the larger credit unions are well advanced in machine accounting techniques.

In conclusion, it should be noted that, due to the rapid growth of many credit unions from relatively humble beginnings to institutions of substantial means, outmoded procedures and insufficient or inadequate personnel are frequently encountered. Companies which have credit unions are well advised to make certain that adequate audits are regularly made. The independent public accountant is in an excellent position to perform the necessary audits and make such reviews and recommendations as may be essential to the healthy growth and maintenance of an employees' credit union.

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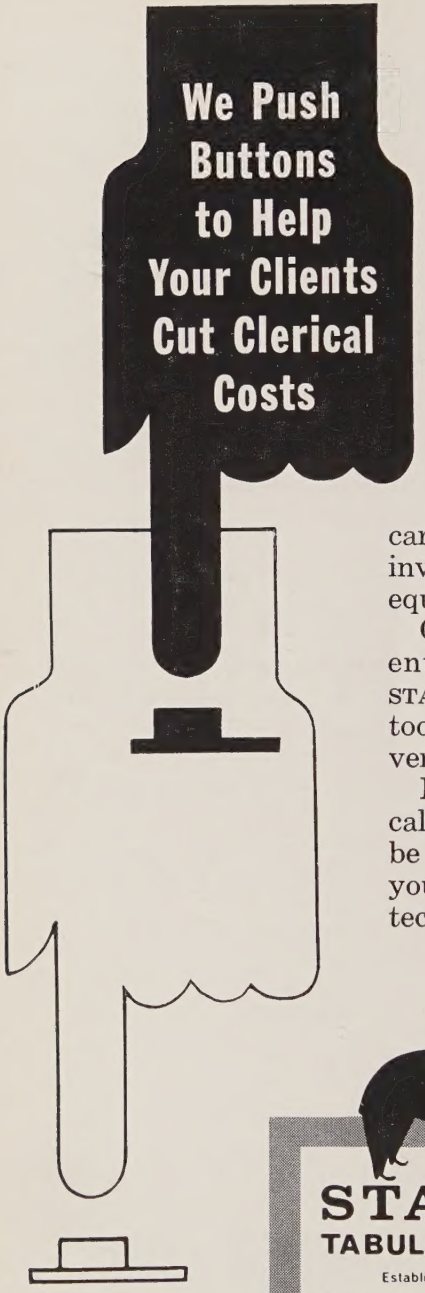
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